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THE JOURNAL OF FINANCE

Vol. V MARCH, 1950 *No. 1*

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THE PRESENT STATUS OF MONETARY AND FISCAL POLICY *Paul W. McCracken*

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CAPITALISM AND ECONOMIC STABILITY: DIRECT VERSUS MONETARY AND FISCAL CONTROLS

RECENT DEVELOPMENT AND EVALUATION OF DIRECT CONTROLS*

ROBERT C. TURNER
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Controls similar to those in effect during World War II are what we usually have in mind when we speak of "direct controls." These included allocations (including priorities and rationing) of materials, components, and finished products, facilities and equipment, transportation, fuel and power, and manpower; maximum (and in some cases minimum) price control and wage control; public purchase of commodities for private use; control of international transactions, financial and physical; and positive direction of capital formation through government loans, accelerated tax amortization, or direct government investment.

These "direct controls" are legal devices for directing, guiding, or restraining some aspect of economic behavior in which the control device applies directly to the economic process or factor which it is desired to control, in contrast to an indirect control which relies upon action through an intermediary factor.[1] In a sense any control is indirect, in that seldom if ever is the factor or process which is thus controlled the sole and final objective of the control process. Maximum price regulation is usually thought of as the classic example of a direct control. Yet, the ultimate objective of maximum price control, during or following the war, was much broader than simply stable prices.[2]

The closest approximation that I can find of a "pure" direct control is government public works for unemployment relief. Here

* This article and the following two articles by Paul W. McCracken and Everett E. Hagen, with discussions by William W. Tongue and Richard C. Youngdahl, were presented at a joint session of the American Finance Association and American Economic Association at New York City on December 28, 1949. The general subject discussed at the session was "Capitalism and Economic Stability: Direct versus Monetary and Fiscal Controls." The program was under the chairmanship of John K. Langum, The Federal Reserve Bank of Chicago.

[1] It should be noted that this definition is much broader than the popular concept which limits "controls" to coercive devices.

[2] Cf. J. K. Galbraith, "The Disequilibrium System," *American Economic Review*, Vol. XXXVII, No. 3 (June, 1947).

the objective is to provide jobs and incomes to unemployed workers, and it is achieved by hiring the workers and paying them wages. The broader objective, however, is to increase the level of employment and incomes generally, not just those of the workers immediately affected. It is for this reason that public works for unemployment relief are usually classified as an indirect control. Clearly, the distinction between a direct and an indirect control depends not only upon the mechanics involved, but also upon what one conceives as being the ultimate objective of the control.

The discussion in this paper is limited to controls characteristically employed in a short-supply, inflationary situation.[3] These include maximum price and wage control (excluding utility prices and rates), priorities and allocations (including so-called "voluntary allocations") as applied to commodities, construction, and transportation,[4] and export and import controls (excluding tariff.)

Priorities and Allocations

Commodities and construction.—The basic authority for the priorities and allocations exercised over commodities and construction was the Second War Powers Act of 1942,[5] which continued in effect until its expiration date, March 31, 1947. The exercise of this authority was sharply restricted, immediately following VJ-Day and to some extent even before VJ-Day. By the spring of 1946, the controls exercised under the Second War Powers Act

[3] Among the direct controls excluded by this limitation are: (1) agricultural price supports; (2) minimum price supports for metals and minerals. (The premium payment plan, which provided these supports, terminated June 30, 1947, but numerous proposals have been made for its reinstitution. In late summer, 1947, a bill reactivating the premium payment plan was passed by both houses of the Congress but was vetoed by the President. In the recent session, another more restricted bill [limited to strategic metals and minerals (ores) which would otherwise be abandoned and lost] was passed by the Senate but not by the House. The issue is almost sure to be a live one in the coming session of the Congress.) (3) Minimum wages. (4) RFC loans made for the specific purposes provided in the RFC Act (Public Law 548, 80th Congress), "to encourage small business," and "to help in maintaining the economic stability of the country, and to assist in promoting maximum employment and production." (It is the author's conviction that this type of economic control, i.e., direct government investment in private business, will become a major instrument of social policy if and when the United States moves significantly away from full employment and inflationary pressures. Evidence of this is already seen in the statements by the President regarding RFC policy in the last Mid-year Economic Report.)

[4] Priorities and allocations as applied to manpower are not discussed because the only significant postwar development in respect to these controls is the alacrity with which they were abandoned after the war. The only exception would be Selective Service which, however, is scarcely an economic control.

[5] 56 Stat. 177-180, Ch. 199, Title III.

were limited to those necessary to support the veterans housing program, certain controls necessary to supplement price control (e.g., in textiles), continued allocation of various raw materials in critically short supply (chiefly of foreign origin), and priorities and allocations for export. The exercise of the authority of the Second War Powers Act was further narrowed in the fall of 1946 with the termination of price control. In 1947, the Congress enacted the First and Second Decontrol Acts of 1947.[6] These Acts terminated the priority and allocation powers of the Second War Powers Act, except for certain specified purposes, including (1) allocations[7] of a few raw materials: cinchona, manila, agave, tin, antimony, and streptomycin (rubber was covered in separate legislation); and (2) allocations for export where necessary to expand foreign production of materials critically needed in the United States, and of exports and imports where necessary to carry out the foreign policy of the United States.[8]

During the fiscal year 1949, exercise of the controls authorized by the amended Second Decontrol Act were reduced in coverage or terminated by administrative discretion. Export priorities became unnecessary as more and more products came into adequate supply. In June, 1949, the entire Decontrol Act was allowed to die except for two provisions, allocations of tin and tin products,[9] and import control of fats and oils and rice.[10] Allocation authority over tin would have also been terminated, except that a revolution in Bolivia broke out at the right moment. It was feared that disruption of tin mining in Bolivia might again tighten the easing tin position. Since then, tin supplies have become relatively abundant, the price has fallen (partly as a result of devaluation), private importation has been resumed, and all restrictions on the use of tin have been eliminated.

[6] Public Law 29 and Public Law 188, 80th Congress.

[7] The term "allocations" was construed broadly, to include all forms of priorities and allocations, export control and import control. Export control was also, however, covered by other specific legislation.

[8] The First Decontrol Act, enacted in March, 1947, was a temporary act, and was superseded in July, 1947, by the Second Decontrol Act which continued the authority of the First Decontrol Act with numerous minor changes, chief of which was restriction of import controls to fats and oils, rice, and nitrogenous fertilizer materials. A year later, in June, 1948, the Second Decontrol Act was extended until June 30, 1949, and amended by deleting allocation authority for cinchona and by adding a requirement (and authorization) that half the nitrogenous fertilizer exports to non-occupied areas be supplied by Army-owned plants.

[9] Public Law 153, 81st Congress.

[10] Public Law 155, 81st Congress.

Prior to the 1949 legislation, import controls (in the Decontrol Acts) on fats and oils, rice, and nitrogenous fertilizers had been employed to insure United States conformance with international allocations of materials in world short supply. A new purpose is specifically added in the authorizing legislation, however, to protect the domestic price when a "temporary surplus" exists in the United States. Import controls on rice and fats and oils, presently in surplus supply in the United States at price support levels, are now exercised for this latter purpose.[11] (International allocations of rice are still in effect but will terminate on January 1, 1950.)

Rubber has been covered by separate legislation since the spring of 1947. Rubber presents a unique problem occasioned by its strategic importance and the existence of a large, government-owned synthetic rubber industry, built during the war. There is universal acceptance of the basic principle that a synthetic rubber-producing industry must be available to the United States in the event of another war. It is also generally agreed that government regulation to accomplish this purpose should be used if necessary but should be held to a minimum, and that the industry should be transferred to private ownership as soon as practicable. How to accomplish these objectives, however, constitutes a difficult problem.

During the first two years or so after the war, natural rubber was in such short supply that there was an ample market for synthetic rubber and the problem was solely one of allocating the available supply of natural rubber. In March, 1947, however, the Congress took cognizance of the gradually improving natural rubber supply situation by authorizing for one year[12] the continued exercise in respect to rubber of the Second War Powers Act allocation powers. A year later the Congress enacted the Rubber Act of 1948,[13] which authorized the President to exercise controls to insure the consumption of at least 222,000 long tons of synthetic rubber, provided for the maintenance of a total of 665,000 long tons of synthetic rubber capacity (active plus standby), and required that by January 15, 1950, the President recommend appropriate continuing legislation to the Congress.

[11] The problem is particularly acute in the case of flaxseed and linseed oil. Flaxseed was largely an import commodity before the war, but United States production was greatly expanded during the war, and the Department of Agriculture now holds large surpluses acquired at support prices, which are now well above world prices.

[12] Public Law 24, 80th Congress.

[13] Public Law 469, 80th Congress. This act expires June 30, 1950.

In the main, the Rubber Act of 1948 continued the previously existing policies and control procedures. However, one very important administrative change has been made since the Act was passed which, although it does not affect the practical application of the control system, does involve an entirely diffrent basic legal concept. The controls exercised were formerly negative in character, i. e., manufacturers of rubber products were prohibited from using more than a given percentage of natural rubber to total new rubber in the manufacture of specified rubber products. The present controls, however, are positive. Manufacturers are required to use synthetic rubber in at least a minimum percentage of total new rubber consumption in the manufacture of specified rubber products.[14] The use of this positive type of control is consistent with the purpose of the Act—to insure the continued existence of a synthetic rubber industry. It is nevertheless an unusual exercise of government powers to require a manufacturer to use a specific raw material if he is to continue in his regular business, and would be an extraordinary exercise of power if the synthetic rubber plants were privately owned. It is this aspect of the control program which renders disposal of the synthetic rubber plants to private industry so difficult.

The broadest area in which priorities and allocations were used in the postwar period was the Veterans' Emergency Housing Program. Exercise of the priority and allocation powers took a number of forms, including priorities and allocations to channel materials and equipment into veterans' housing, limitation on nonresidential construction, and veterans' preference in the sale and rent of new housing units.[15]

[14] Special purpose synthetic rubbers (including butyl rubber for inner tubes) are now definitely superior to natural rubber in their areas of use, and general purpose synthetic rubber (GR-S) is the approximate equal of natural rubber for the bulk of general purpose uses (chiefly passenger car tires). In the absence of mandatory consumption, price differentials, especially between GR-S and natural, would probably be the primary determining factor in the choice between the two rubbers.

[15] Cf. William Remington, "The Veterans' Emergency Housing Program," *Law and Contemporary Problems*, Vol. XII, No. 1 (Winter, 1947), and Joseph L. Rauh, "Government by Directive," *Harvard Law Review*, Vol. 61 (November, 1947). The controls were exercised jointly by the Housing Expediter and the Civilian Production Administration. The Veterans' Emergency Housing Act of (May) 1946, not only gave the Housing Expediter independent priority and allocation powers, but also gave him unprecedented powers to issue directives on matters directly or otherwise related to the Veterans' Emergency Housing Program to any of the executive agencies of the federal government, requiring them to do all things which were legally within their powers.

When prices were decontrolled in November, 1946, the Housing Expediter announced that all controls save ceiling prices on building materials would be kept in force. However, price decontrol, coupled with the general attitude of the 80th Congress toward direct controls, sounded the death knell of the Veterans' Emergency Housing Program. Inflation soon took over and provided a powerful stimulus to home construction, although not necessarily in price ranges available to veterans. In the summer of 1947, the program was dropped except for enforcement of previously issued priorities and allocations and continued veterans' preference in the purchase or rent of new dwelling units not built for owner-occupancy.

In brief, the direct priority and allocation controls originally authorized in the Second War Powers Act, as applied to commodities, have now been telescoped to allocations (chiefly specification control) of synthetic rubber, import controls of fats and oils, and rice, and veterans' preference for housing. In all of these materials, rubber, fats and oils, and rice, the controls are now being used for distinctly different purposes from those in effect during and immediately following the war. Authority to allocate tin continues in effect but, by administrative discretion, the controls have been terminated.

Although the priorities and allocation program has been a constantly narrowing one, it has played a vitally important role in insuring a distribution of materials in short supply which would best serve the public interest. The housing program would probably have been more effective if it had been developed in a slightly more deliberate way, with less of an atmosphere of frantic urgency. It nevertheless gave a stimulus to housing construction that could be equalled only by the stimulus that succeeded it, gross inflation. Adequate supplies of tin were assured for food preservation and essential industrial uses by denying it to toys and trinkets. Cinchona (quinine) was used for medical treatment of malaria rather than for patent medicines of dubious value. Controls on rubber have permitted a maximum quality of rubber product within the limits of the natural rubber supply, have prorated the effects of the shortage equitably among rubber manufacturers, and more recently have assured the continued existence of the synthetic rubber industry in the interests of national security. Import controls permitted the United States to limit to an equitable share its take of the supply of materials in world short supply, rather

than use its financial power to raid the world's markets. With varying degrees of success, the allocation controls prevented or limited extreme increases in prices which would unquestionably have occurred if the allocation controls had not been in effect. In this respect, it may be significant that the Congress was fairly willing to authorize allocation of imported materials, but balked at similar proposals for domestically produced materials.

Price controls were a necessary supplement to priority and allocation controls in the first year after the war when the control program was a broad one. In fact, it was the collapse of price control in the fall of 1946 more than any other single factor which brought about the early end of the veterans' emergency housing program. The attempt to channel textile production into fabrics for low cost garments, never very successful, had to be abandoned entirely with the end of price control. In later years, however, the specific priority and allocation controls in effect did not require supplementary price control. In the spring of 1947, for example, fears were expressed that the termination of exclusive public purchase of natural rubber (a device for controlling prices among other things) would undermine the allocation control program; such, however, did not prove to be the case. Similarly, there was relatively little circumvention of export priorities by price manipulation.

Postwar experience with priority and allocation control, although limited, provides some evidence as to the circumstances under which such controls can be effective. First, there must exist a substantial area of public support and recognition of the need for the controls, else violations become so numerous as to defy enforcement. This is less true, however, of controls which apply at the producer level than at the consumer level (e. g., tin for tinplating). Second, as the area affected by the control system widens, the difficulties of administering the system increase disproportionately. If only a small percentage of manufacturers' order books are subject to priorities, few complications arise. But as the proportion rises to 30, 40, or 50 per cent, the conflicts become very serious. The phrase used in the War Production Board was "Priorities breed priorities." Third, priority and allocation controls are likely to require supplementary price controls. This is not necessarily always the case. If the controlled commodity is a highly standardized one, circumventions of the allocation system by spurious quality differentials are not easy. Similarly, if the allocated material is

one characterized by well-known market prices, established either in public markets or by a few, dominant producers, price control is not so necessary. If the control system is very extensive, however, and especially if there is much resistance to it, supplementary price control is likely to be necessary.

New priority and allocation controls.—New powers have been authorized since the war by Congress in two areas. The first is the quasi-allocation powers in the so-called Anti-Inflation Act of 1947,[16] which formed the basis of the "voluntary allocations" program, and the second is the sweeping priority and allocation powers contained in the Selective Service Act of 1948.[17]

The voluntary allocations program was born in January, 1948. On the previous December 31, the Congress had responded to the President's sweeping requests for anti-inflation controls with the Anti-Inflation Act of 1947, which authorized the President to negotiate *voluntary* allocation agreements with representatives of industry, business, and agriculture, for the purpose of insuring the fulfilment of essential production programs and combatting inflationary pressures, and provided certain anti-trust exemptions for persons participating in such agreements.

Nineteen agreements were negotiated, eighteen covering steel and one involving pig iron. The principal areas covered by the agreement were: railway freight cars (which accounted for over one-half of the total steel tonnage "allocated"); barges and towing vessels; oil tankers; certain merchant ships; manganese ore cars for South Africa; certain Atomic Energy Commission construction projects including a pipe line; numerous housing materials including factory-made steel houses; mining machinery; tank and oil field production equipment; farm-type grain storage bins; export steel for ECA countries; and the requirements of the armed forces, the federal aeronautical agencies, and certain federal reclamation projects. At the peak of the program (May, 1949), about 580,000 tons of steel a month were allocated, or about 10 per cent of United States production.[18]

In the limited areas in which voluntary agreements were negotiated, the allocations were moderately successful. There were num-

[16] Public Law 395, 80th Congress.

[17] Public Law 759, 80th Congress.

[18] The percentages for certain shapes ran considerably higher — as high as 33 per cent in the case of steel plates. Cf. "Allocation of Scarce Commodities through Voluntary Agreements, A Report by the Office of Industry Cooperation," U. S. Department of Commerce, September 30, 1949.

erous instances where participating consumers were not able to obtain their "allocated" steel, and the fact that prices were not fixed (the law specifically prohibited price-fixing) meant that certain inequities and circumventions of the voluntary agreements resulted. Nevertheless, the voluntary allocation agreements, where they were in effect, made a substantial contribution toward meeting the minimum, essential requirements of certain key fields of industry.

Such success as was achieved in the voluntary allocations program may be attributed fundamentally to the implied threat in the legislation that coercive powers would be authorized if industry co-operation was not forthcoming. The device was applied only to the iron and steel industry, an industry that was particularly subject to the pressure of public criticism during this period. Numerous proposals for voluntary allocations of other materials in short supply were rejected or shelved.[19] In consequence of the easing steel supply situation in the spring and summer of 1949, the voluntary allocations program died quietly on September 30, 1949, when the enabling legislation expired.

The Selective Service Act of 1948 contains two provisions authorizing the exercise of direct priority and allocation controls. The first (Section 18*a*) authorizes the placement of mandatory orders for articles or materials needed exclusively for the use of the armed forces or the Atomic Energy Commission and requires that such orders be given priority. The Second (Section 18*h*) authorized the President to require all steel producers to make available equal proportions of their production to persons producing on military contracts. In both cases, seizure of the facility is authorized if compliance with the order is not forthcoming.

Both of these powers were inserted in the Act somewhat unexpectedly, to couple the power to draft men with power to "draft industry." Neither power was specifically requested by the Administration, and after the bill was enacted, there was some uncertainty as to just what to do with these sweeping but unsolicited powers. A week after signing the Act, the President announced that he did "not consider it appropriate to invoke the authority

[19] The Department of Agriculture developed an allocation agreement covering the use of grain by brewers, but was unsuccessful in persuading the distillers to accept a similar agreement. As a consequence neither was put into effect. Numerous other proposals for allocation agreements were made to the Departments of Commerce and Interior, but for a variety of reasons no agreements were consummated.

contained in Section 18*h*" at that time, and instead asked that a voluntary allocations program covering the requirements of the armed forces for steel be developed. Later the President further announced that the use of the mandatory order authority of Section 18*a* was unnecessary at that time, but that the situation would be closely watched, so that if it should later appear that the power was needed, the authority could be promptly invoked. Neither of these powers has been exercised; in fact, no delegation of the Presidential powers—a practical prerequisite to exercise of powers—has been made.

Railroad transportation.—Controls over railroad transportation like those over commodities and construction were derived from the Second War Powers Act. During the war, these controls were very extensive and covered all forms of domestic transportation.[20] By December 31, 1945, however, all controls had been abandoned save those applying to railway freight traffic.[21] The controls exercised were directed primarily toward increased loading of cars, control of shipments to port to prevent port congestion, and reduced turn-around time through restrictions on car detention and increased demurrage charges. They were instrumental in reducing the aggregate impact of the car shortage and in preventing transportation crises from developing which could have caused serious economic losses, particularly during harvest seasons. Efforts to relieve the freight car shortage by building new cars ran head-on into the steel shortage. A voluntary steel allocation program for building 10,000 freight cars a month was therefore developed by the Office of Defense Transportation. This program, after a very slow start, finally resulted in car production approximating, and in a few months exceeding the 10,000 car-a-month goal.

In the spring of 1949, the gradual increase in the supply of cars and the decline in business activity caused the car shortage to turn into a small surplus. The controls were therefore relaxed and when the enabling legislation expired on June 30, no request for extension of the authority to allocate railroad transportation was made. The controls accordingly were terminated. This action was taken in the knowledge that, should a serious car shortage

[20] Except horse-drawn vehicles, the exclusion of which caused a few difficult moments for the Office of Defense Transportation.

[21] Controls over certain other forms of transportation were reinvoked briefly during the railroad strike in the spring of 1946. Also, between October 16 and 30, 1946, controls were exercised over the loading of grain by American vessels on the Great Lakes.

reappear, the somewhat more restricted and less flexible powers of the Interstate Commerce Commission could be employed.

EXPORT CONTROL

In contrast to other direct controls, export control[22] has continued to be authorized on a broad and relatively unrestricted basis ever since the war. The present authorizing legislation expires on June 30, 1951. During the interval since the war, however, there have been important changes in the character and purposes of export control.

Export control had two main objectives during the war: first, to protect the domestic economy from an unwarranted drain of supplies into export, and especially to prevent exports from having an undue impact upon military production; and second, to influence the economies of foreign countries and thus to assist in the accomplishment of foreign political and economic objectives. Export control for this latter purpose is a phase of "economic warfare."

In the postwar years, until early 1948, the former purpose (protection of the domestic economy) was dominant. The emphasis was shifted from protection of war production to protection of civilian supply wherever shortages persisted, and to protection of domestic prices from the impact of large foreign demand. The second purpose, however, usually called "economic sanctions" in peacetime rather than "economic warfare," was definitely subordinated. Sanctions against Argentina were continued for a few months following VJ-Day and were continuously in effect to a limited degree against Spain. With these and a few other minor exceptions, however, restrictive export control action for the purpose of exerting economic pressure on non-co-operating foreign countries was not employed. The purpose of export control was largely protection of the domestic economy, and the number of items on the "Positive List," (i.e., subject to export control) was reduced as rapidly as improvements in domestic supply permitted.[23]

[22] For purposes of this paper, the term "export control" is used in its more commonly accepted sense to cover only *restrictive* measures which limit export. In a previous monograph (*Export Control in the United States during the War and Postwar Periods*, Washington, D. C., School of Advanced International Studies, 1947), I defined the term more broadly to include *positive* instruments (priorities and allocations) for influencing the volume and character of exports.

[23] A third purpose, assisting in the carrying out of international allocations, was present in respect to some commodities. Export control could limit exports to allocated amounts (although it could not assure the export of these amounts), and it could direct exports to the proper destinations.

In early 1948, however, the situation was suddenly changed. Relations with Russia had deteriorated to the point where close control (and virtual elimination) of shipments to Russia were demanded. At first, the export control authorities moved with diplomatic restraint, reinstituting export control of all shipments to *all* of Europe for the announced purpose of assuring maximum utilization of American resources in furthering the purposes of the European Recovery Program. Before many months had passed, however, it was frankly admitted in all quarters that the primary purpose of the tightening and extension of export control was to prevent the use of United States resources to strengthen the Russian military potential and to impose economic sanctions on Russia and her satellites.[24]

The decline of business activity in the first half of 1949 brought into ample supply most materials subject to export control, including notably steel, coal, petroleum, and building materials. Consequently, export control for the purpose of protecting domestic supply has now been reduced virtually to the vanishing point. At the same time, export control for national security purposes has been strengthened. From the point of view of the purpose of export control, therefore, the situation is just the reverse of what it was two or three years ago. The character of the list of items subject to export control, and the instruments of control, have been correspondingly modified to reflect the realignment of objectives.

Price Control

Postwar developments in price control are too well known to require detailed comment. However, a brief review of some of the factors contributing to the collapse of price control in 1946 may be of assistance in evaluating this type of direct control.

The effectiveness of direct price control during the war can be attributed primarily to the fact that powerful motives were present to persuade people to save very large proportions of their money incomes, and in consequence current saving came within "shooting distance" of being enough to maintain a balance between the

[24] The Export Control Act of 1949 (Public Law 11, 81st Congress, 1st Session) declares it to be "the policy of the United States to use export controls to the extent necessary (*a*) to protect the domestic economy from excessive drain of scarce materials and to reduce the inflationary impact of abnormal foreign demand; (*b*) to further the foreign policy of the United States and to aid in fulfilling its international responsibilities; and (*c*) to exercise the necessary vigilance over exports from the standpoint of their significance to the national security."

demand for and the supply of goods and services available to consumers at existing prices. Not the least of these motives was a profound faith on the part of many people that saving — buying war bonds — was necessary to war production and would therefore help directly to win the war. Still another motive was the selfish one of wanting to retain purchasing power so as to be able later to buy goods, chiefly consumer's durables, that were not then being produced. The pressure of demand became well-night intolerable when these incentives to save were removed.

A second factor which contributed to effective price control during the war was the existence of almost universal allocation controls in the production field, and of a substantial area of consumer rationing. When a large proportion of the structure of allocation controls was junked in the weeks immediately following VJ-Day, the difficulties of price control were multiplied.

A third factor was public self-discipline. The policing job in enforcing general price control is virtually impossible in the absence of self-discipline by the vast majority of the people. During the war, in spite of a significant amount of violation of price control regulations, and a greater amount of dissatisfaction with the mechanics of price control, there was widespread support of their basic purpose. "Public acceptance of the principle of price control was the cement that held the structure of controls together. As it lost its cohesive power — almost as soon as victory became relatively certain — the structure began to crumble."[25]

A fourth factor was the unwillingness of the Congress to authorize price control for any reasonable length of time. Short-run price control is, almost by definition, an impossibility. Even in the winter and spring of 1946, the mounting political opposition to price control became so strong as to indicate clearly that the days of price control were definitely numbered. What sealed the doom of price control, however, was the Price Control Extension Act of 1946,[26] which was not a price control act at all, but a decontrol act. Not only did the Act specifically require the prompt decontrol of many items, but it provided that the general control of prices "be terminated as rapidly as possible . . . and in no event later than June 30, 1947, and on that date the Office of Price Administration shall be abolished." In the face of this legislation, only the most

[25] M. G. de Chazeau, "Prices: Wartime Heritage and Some Present Problems: Discussion," *American Economic Review*, Vol. XXXVII, No. 2 (May, 1947).

[26] Public Law 548, 79th Congress.

naive wishful thinker could anticipate continuation of price control beyond June 30, 1947. In a market where inflationary pressures are strong and where it is a good gamble that they will continue to be strong for some time ahead, the possibility of withholding goods from market is so great as to require that attempts at price control come to an end at least six months to a year before the expected termination of the legal authority for price control. It is an interesting fact that some of the greatest pressures on price control in the fall of 1946 came from the withholding from market of relatively perishable items such as meat, hides and skins, and fats and oils.[27]

These factors apply to general price control. Do they necessarily apply to price control of specific, selected items, such as that proposed by the President on several occasions? Clearly, even selective price control requires authorizing legislation which is both effective, and, if the controlled product is one that can be hoarded, of long enough duration to discourage withholding from market. Selective price control also requires widespread public recognition of the need for, and support of, the purpose of such price control. Whether or not corresponding allocation and consumer rationing controls are needed depends upon the structure of the producing industry and the character of markets for the commodity. In the case of items characterized by inelastic demand, of fixed-supply items, and of items produced by a small number of large producers, especially where administered pricing is typical, voluntary or accidental rationing, to the extent that it is needed, may prove to be adequate. Such voluntary or accidental rationing, however, produces a distribution of the price-controlled item different from that which would result in a free market, and may involve serious inequities.

Whether or not selective price control requires a large volume of saving, and adequate motives to assure it, depends upon the degree of general inflationary pressures and the purpose of the price

[27] The factors mentioned are not intended to constitute a complete catalogue of the forces leading to the collapse of price control. Among other factors which should be mentioned were: the collapse of wage controls and the positive support given to hourly wage rate increases in the fall of 1945; the great expansion of new items which had to be price-controlled after wartime restrictions on production were lifted; the fact that under the best of circumstances price control becomes increasingly difficult with each passing month simply because patterns of relationships between prices which may have been rational when controls were originally imposed become more and more unrealistic as time elapses and conditions change; and the inability or unwillingness of the OPA to yield from its rigid pricing formulas and standards for the purpose of keeping down political pressures.

control. If the purpose is only to control the prices of the commodities specifically covered, because it is believed that these particular prices are "out-of-line" and are causing unreasonable hardships, or for other reasons, no such saving is necessary. But in the absence of such saving, the effect of selective price control will be largely limited to its purpose, control of the selected items. The demand thus released (or not absorbed) in the controlled items will tend to spill over into uncontrolled items. In the long run, therefore, the *average* level of prices may be unaffected by the selective controls. In brief, in a situation where there is a disequilibrium between aggregate effective demand and the aggregate supply price of goods and services, selective price control alone cannot restore equilibrium.

A modification of this generalized statement is required by the fact that our economy is dynamic, not static, and is not characterized by highly competitive and rational behavior in many areas. In an economy where a large number of prices are administered, selective price control may slow down the inflationary process. This is particularly likely to be true where the price-controlled items are basic cost-of-living items, or basic industrial materials which enter the production process at an early stage. In a full-employment economy, the bargaining position of labor is strong, and union demands are influenced in an important degree by actual or anticipated changes in the cost of living. Similarly, increased basic materials costs are often seized upon as adequate reason or excuse for increasing administered prices. To the extent that labor's demands are moderated by price control of basic cost-of-living items, and that basic material costs are fixed, the process of upward readjustment from a disequilibrium situation takes the slower route of excessive demand for goods in general leading to upward adjustments in prices (many of which are administered prices and slow to adjust to changes in demand) rather than the direct route of increased costs and corresponding increases in prices.

Selective price control highlights a problem that is present in any price control effort: the problem of interrelationships of prices. Price control of any selected item tends to lead to maladjustments which either work hardships or require price control elsewhere. Control of the price of steel may lead to a need for control of the price of ore, which may lead to need for control of the price of haulage on the Lakes, which may lead to need for control of the

price of fuel oil, and so on. I do not mean to exaggerate the significance of this factor. If the area of selective price control is narrow enough, if the items controlled and closely related items are characterized by administered rather than highly competitive pricing, and if price control is not attempted for too long a period of time, it may be possible to ignore these interrelationships. Or it may be possible to adjust the controlled prices sufficiently to prevent the distorted price relationships from breaking down the system and at the same time, with enough "dragging of the feet," to maintain reasonably effective price control. But the problem remains and is much more likely to be disruptive where only certain prices are controlled, and others are free to fluctuate in response to changing demand-supply circumstances, than where all prices are frozen into a pattern which, at the time of the freeze at least, approximated a balanced set of relationships.

An example of the application of these factors is seen in the one selective price control now in force: rent control. No attempt is being made to control rents of newly constructed housing units,[28] because they can be withheld from market, i.e., not built in the first place. Old residences, on the other hand, cannot very well be hoarded because the product controlled is a perishable service — the time-use of existing housing units. Some of them, chiefly single-family units, can be withdrawn from the rental market by selling them in a market where there are no landlord buyers. To the extent that this is possible, the effects of hoarding can be achieved. Fortunately for the effectiveness of rent control, however, this is not possible for the majority of rental housing units.[29]

There is general public acceptance of the need for, and approval of, the purpose of rent control. It has been generally believed (and I believe correctly so) that because housing is largely a fixed supply item, rents would rise exorbitantly in the absence of rent controls — probably substantially more than have prices in general. Moreover, the persons forced to meet this extraordinary increase in living costs would, in the main, be those least able to afford it. This popular support for rent control, however, seems to be gradually waning (less so in large cities) partly as a result of the propaganda of the organized real estate interests, but also because the proportion of the total number of families benefiting from rent control is steadily diminishing as home ownership is

[28] All housing units completed after February 1, 1947.

[29] A substantial shift in housing ownership, from landlord-ownership to occupant-ownership, however, has occurred in the last several years.

forced through sale of rental units, as new housing units, rental or otherwise, are completed, and as specific areas are decontrolled.

Priority and allocation control has not been a necessary supplement to rent control because the control has been limited to existing units, i.e., to a fixed supply. If rent control were to apply to new construction, allocations of building materials and control of competing construction would be the only alternative to a virtual stoppage of construction of rental units. There is some evidence that the lack of rationing of rent-controlled housing has resulted in a degree of *consumer* hoarding of housing, i.e., under-utilization of housing by single persons or families in a position to take advantage of controlled rents. Studies by the Housing Expediter, however, indicate that although there are numerous isolated instances of such hoarding, it does not constitute a serious, general problem.

Distortions of price relationships may arise even in a fixed supply item, however, to the extent that maintenance and operating costs are involved, and to the extent that rates of return on investment in rental property become inequitable as compared with rates of return available elsewhere. In administering rent controls, therefore, the Housing Expediter has to walk a narrow path between a rigid adherence to existing ceilings, ignoring the distortions with related prices thus created, and the making of concessions (increased rent ceilings) to reflect all changes in related prices or alternative investment returns. Effective rent control requires that the rent administrator yield to the pressures caused by these distortions of price relationships (and probably to straight political pressures as well), but yield gradually enough that the rent control program remains generally effective. Congress was apparently convinced that there was too much gradualness in this yielding process when it wrote into the law specific provisions requiring the Housing Expediter to make adjustments in rent ceilings to the extent necessary to "yield to landlords a fair net operating income," and to take into account, in calculating net operating income, a variety of cost factors specifically enumerated, and when it further provided for local option in rent decontrol.[30]

It seems probable that, in the long run, the rise in the average price level (including rents) would be about the same, with or without rent control. This is particularly true because a large proportion of those who are the beneficiaries of rent control are in the lower income groups, where propensities to consume are high,

[30] Public Law 31, 81st Congress.

whereas landlords are generally in somewhat higher income groups where propensities to consume are relatively lower. On the other hand, it is a moral certainty that union demands would have been much more extreme and aggressive if rent controls had not existed. To this extent, rent control has resulted in a more gradual readjustment to higher price levels than would otherwise have prevailed.

Wage Control

The conclusions drawn with regard to price control generally apply to wage control. The problem of interrelationships of prices is especially relevant. The experience of the war and immediate postwar period amply demonstrated that effective price control is impossible without some form of wage control and that effective wage control requires price control. Although there was some reluctance to admit to this reality in 1945-46, subsequent price control recommendations by the President have frankly recognized this necessary relationship.[31]

The proposed Economic Stability Act of 1949 (H.R. 2756, the so-called Spence bill),[32] "weasels" on this point. It provides for direct price control, but not direct wage control. Instead, it provides that a wage increase granted by an employer may not be considered as an increase in cost of production for the purpose of adjustments in price ceilings until six months after the effective date of the wage increase, except to the extent that the wage increase has been found by a "Temporary Wage Board" to be necessary for certain purposes: to compensate for increases in the cost of living, to correct inequities in the wage structure, to correct substandards of living, or to maintain essential levels of production. The effect of such a provision would be to throw the burden of wage control on employers, except to the extent that increases were approved by the Board, in which case corresponding adjustments in price ceilings are made. This "ducking" of governmental responsibility, plus the liberal standards for approval of wage increases, would

[31] The President's Economic Report of January, 1948, states, (p. 51): "In areas where price control might be employed, its workability might be impaired by excessive wage increases. I therefore repeat my recommendation to the Congress that authority should be granted to prevent wage increases where such action is necessary to maintain any price ceiling that may be established." This recommendation was repeated in July, 1948 and in January, 1949.

[32] This bill should not be confused with the Economic Expansion Act of 1949, the Murray amendment to S. 281, committee prints of which were widely circulated before it was introduced. This bill contained no provisions for price or wage control; it was directed at deflation.

scarcely provide a sound basis for either effective wage or price control.

The factor of public acceptance is, of course, critically important in the case of wage control. Voluntary compliance with wage controls during the war was far from perfect, but it made the difference between a reasonably successful and an unsuccessful price and wage control program. Whether or not a similar degree of public acceptance of wage control could be achieved in peacetime is, to say the least, an open question.

General Evaluation of Direct Controls

Direct controls cannot be evaluated in the abstract or collectively. Their value depends upon the type of control, its legal foundation, and way in which it is administered, the character of the economic and political situation in which it is employed, and the purposes for which it is used. Nevertheless, a few very generalized conclusions can be drawn.

First, direct controls are useful only if a much broader foundation of public support exists than is necessary for indirect controls. Because a direct control is direct, it is relatively easy to trace the line between cause and effect, whereas with an indirect control the impact of the application of the control upon various individuals and conflicting income groups may be concealed behind the shadowy veil of money.[33] Indeed, the power of pressure groups being what it is, it may be safe to conclude that there are only two situations in which *restrictive* direct controls can be used on a *broad* scale: (1) where there exists a general, overwhelming motive which largely submerges the motives of private interest groups (such as in a war); or (2), where the conflict of interest groups is so small that the direct controls are not seriously needed.

Second, most direct controls, and especially price controls, require legislative authorization which extends a reasonably long way into the future. It can be anticipated that, some time in advance of the known termination date of a control, the problem of assuring compliance will become difficult, and perfectly legal actions, such as hoarding, which undermine the control will be resorted to. The practice of many local governments of decontrolling rents as of a date some months in the future is particularly fatuous.

[33] Cf. G. L. Bach, "Monetary-Fiscal Policy Reconsidered," *Journal of Political Economy*, Vol. LVII, No. 5 (October, 1949).

Third, a direct control is much more likely to be effective if it renders an incidental benefit to the controlled persons (as in the case of rubber). On the other hand, there is a danger of the control system being used as a device for restricting trade or controlling prices. It requires very wise administration of a control system to obtain the support and co-operation of the controlled industry, through benefits provided, and at the same time to avoid circumvention of the purpose of the anti-trust laws.

A fourth generalized conclusion is that, in situations conducive to their effective operation, direct controls possess some distinct advantages over indirect controls. They are reasonably fast in their operation. They can be manipulated frequently and quickly to meet the needs of a developing situation (in contrast to fiscal policy, for example, which must be set a year ahead of time and the full effects of which carry beyond that year). Moreover, the results are reasonably certain and where certainty is of vital importance it may be necessary to use direct controls even though the same results might be accomplished by indirect controls. Evidence of this is found in the apparent willingness of Congress to authorize direct controls fairly freely for the one purpose held uppermost, national security. Economic stability runs a very poor second to national security.

Fifth, there is a considerable tendency for direct controls to lead to further controls. I believe this point has been considerably exaggerated in public discussion. There is no serious "contageousness" to direct controls, under some circumstances, particularly where the area of control is small, or where the commodity controlled is a fixed supply item. Evidence of this is found in the successful postwar application of allocation controls of scarce raw materials and of rent control. But as the area of control increases, the need for corollary controls tends to be compounded. Effective price control may require allocation control, either at the producer level or rationing at the consumer level. Conversely, effective allocation control may require price control if only the limited type which requires a producer to sell an allocated commodity at the same price that he sells to other similar buyers. Similarly, price control (except of fixed supply items) tends to lead to wage control, and wage control certainly requires price control. Any partial control system involves problems which it may be possible to solve, but which may be solved only by some sacrifice in the efficacy of the control system.

Finally, direct controls are most useful where the pressures and the fluctuations are very strong — too strong to be handled by the weaker and more cumbersome indirect controls alone. In situations of this character, the results that can be achieved by direct controls (used in conjunction with indirect controls) may compensate far more than for the social costs of their use. In lesser situations, however, it may be better, in the main, to put our reliance on less effective but less demanding alternatives.

THE PRESENT STATUS OF MONETARY AND FISCAL POLICY

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The successive developments in monetary and fiscal policy, as Williams has pointed out, have been toward gaining progressively more initiative in influencing the volume of aggregate spending and national income.[1]

Discount policy seemed insufficient because a low discount rate, for example, encouraged but did not guarantee an easier reserve position through rediscounting, and therefore an expansion of bank credit, and therefore an upward response by business activity.

Attention gradually shifted to open market operations. With this activity the monetary authority did not have to await the initiative of the commercial banks in the creation of reserves. Through an affirmative use of open market purchases or sales, the Federal Reserve had acquired the initiative in the creation of reserves. But this did not prove to be the perfect answer. Particularly was this true when the problem was to encourage a recovery from low levels of business activity. Excess reserves could be created, but what if people did not want to borrow?

In the thirties our attention turned to the deliberate use of the governmental-receipts spending process as a way of influencing the level of national income. This was basically a logical extension of the evolution of monetary policy. If the private sector of the economy could not be counted on to borrow and thus activate the business situation, we would rely on governmental deficits to precipitate the borrowing and spending. This constituted one further step, it was hoped, toward tightening the relation between policies pursued and results desired — a rise in the volume of spending and national income. So complete was this shift of emphasis, however, that we no longer considered ourselves operating within the ambit of monetary policy. These new policies incident to the governmental-receipts spending process were *fiscal* policies.

[1] John H. Williams, "Deficit Spending," *American Economic Review, Proceedings;* reprinted in his *Postwar Monetary Plans and Other Essays* (New York: Knopf, 1947), chap. 9.

I

Unaccustomed to performing in the role of minister without portfolio, monetary policy looked around for something else to do and found it. This was the maintenance of more orderly conditions in the capital markets. Something which we have heard a great deal about in the war and postwar period, its origin is back at least as far as 1937. In that year, and again in 1939, the Federal Reserve stepped in with open market purchases, not because of pressure on reserves, but "to contribute to the maintenance of an orderly bond market . . ."[2]

The further development of this facet of monetary policy during the war is a familiar story, and I shall not belabor it here. The rate structure from ⅜ per cent on Treasury bills to 2½ per cent on long-term issues was held until 1945, at which time the shift to the longer-term issues forced the Federal Reserve to buy short-terms, which created bank reserves, which abetted the inflation we were attempting to restrain.

With the rising volume of bank loans in 1946 the shift out of governments (short and long) became even more inflationary as the resulting creation of reserves resulted in a creation of new money destined for rather immediate expenditure.

In 1947, non-bank holders also began a substantial unloading of government securities as more attractive alternative earning opportunities developed.

Periodic increases in the short-term rates and an expert use of Treasury surpluses did exert some moderate restraint on the bank credit inflation, but the modest approach (as it was called) inevitably produced comparatively modest results, because financial institutions could always bail themselves out of pressure through sales of government securities at supported prices.

II

Why was the Federal Reserve so reluctant to modify in a more substantial way its support policy during the postwar boom? If it was inflationary during an inflation, why was it not changed?

A consideration of these questions takes us into the heart of the whole concatenation of monetary problems arising out of the *existence* of a large public debt. There were, I think, three main

[2] *Twenty-sixth Annual Report of the Board of Governors of the Federal Reserve System, Covering Operations for the Year* 1939, p. 9.

reasons — all quite short and forthright. They were and are important because they are the background considerations which may well be the raw material for monetary policy again in another boom.

1. A rise in the level of rates would be objectionable because the market value of outstanding securities would fall, the Treasury might experience refunding difficulties, and it would have unfavorable repercussions on financial institutions.

2. A rise (at that time even in short-term rates) would be undesirable "because it would increase the cost to the government of carrying the public debt."[3]

3. There was "even less reason to suppose that it would be of value in combatting inflationary dangers which have arisen from two primary causes, neither of which would be corrected by higher rates."[4]

Since these considerations are still very much a part of our current thinking, it is essential that we examine in order some of their implications.

1. That a rise in rates would induce a decline in the price of outstanding securities (government as well as others) is incontestable. The two effects are basically different sides of the same operation. Whether that rules out the desirability of a rate rise is another question. There is some reason to think, for example, that some considerable part of the unloading of longer-term government securities in the early part of 1948 might have been discouraged if the support prices had been set slightly below par instead of slightly above in late December, 1947. In that case institutions and other potential sellers would have had to face the prospect of converting a paper loss into an actual loss if they unloaded government obligations in favor of higher yielding private debentures or securities.

It is a question of judgment, of course, as to how restrictive a slightly below par price would have been at the time the decision was made in December, 1947. This much it seems reasonable to say. A slightly below-par price probably could have been found which would have imposed a penalty on sales without being so drastic a decline below par as to raise questions about public confidence in securities. And in the process, funds would not have

[3] 1945 *Annual Report of the Federal Reserve System*, p. 5.
[4] *Ibid*, p. 7.

been made quite so readily and automatically available to private borrowers.

A par support policy cannot be justified on the grounds that the solvency of financial institutions would thereby be impaired, though that was a consideration occasionally expressed at the time (and was mentioned in the 1945 report). Most institutions would not have been required to carry their government securities at less than par, and no question of capital loss would have been raised unless they actually had sold the securities—which is precisely what it was desirable to discourage at any event. Furthermore, it has been shown that any temporary disadvantage of higher rates because of lower security prices would very quickly have been offset through higher earnings thereafter.[5]

It may, in fact, be questioned just where the interests of financial institutions lie in the long run — with relatively flexible rates and security prices or with fairly rigidly supported prices and rates. The commitment to support the price of bonds at par is no part of the bond contract. The Treasury initially committed itself to pay, for example, on a $1,000 bond $25 per year and $1,000 on the due date. If now the provision is added that the holder can at any time unload for face value, even long-term bonds become very close to pure cash. It would not then be surprising if some questions were forthcoming about whether 2½ per cent were not a rather heavy interest burden on an obligation with no credit risk and apparently also no market risk.

The commitment to bail the holder out at any time is no part of the contract, that is, at the outset. It can be argued with some force that the longer security prices are prevented from falling below par, the greater does become the moral commitment. And the more confused the public will then get about the extent to which a decline below par is in some sense a breach of promise on the part of the government — a default on its full faith and credit.

2. That a rise in interest rates would increase the interest cost of the debt to the Treasury is scarcely open to question, though the point was probably overemphasized. The rates to be pushed up first were the short-term obligations. And the subsequent "modest policy" demonstrated that comparatively moderate increases periodically made could keep the market enough off-balance to exert considerable effective pressure. Moreover, somewhat

[5] Paul A. Samuelson, "The Effect of Interest Rate Increases on the Banking System," *American Economic Review*, (March, 1945), pp. 16-27.

in excess of $20 billion of government securities were held by the Federal Reserve Banks, and any added interest cost on this part of the debt could be, as it subsequently was, returnable to the Treasury. Nevertheless, the fact still remains that with a $250 billion debt the interest cost will eventually rise at the rate of $2.5 billion per 1 percentage point increase in the interest rate thereon.[6]

Now this brings us to an important aspect of this question. In our discussions of fiscal policy, a major limitation to an expansion of the public debt was considered to be the interest charge relative to national income.[7] Our postwar experience raises the question as to whether this is *the* burden. Nevertheless it is certainly an important one, and I think we are justified in raising the question as to whether, in view of a tax and deficit conscious Congress, the limitation imposed by this burden is not already beginning to press in upon us at around 2 per cent of our gross national income. It may be that the trouble arises because Congress takes too narrow a view of this limitation. They are not sufficiently aware that economists are prepared to be sanguine about even larger relative transfer payments. (Economists qua economists, that is, are thus sanguine. The views of economists qua taxpayers, one observes, are often not so different from those of more common clay after all.) The plain fact is that the jaundiced view which Congress would take of a request for more money to pay higher interest rates on the public debt does constitute a very serious problem with a debt the present size and is already a real limitation to a rational debt management policy during a boom. In the present state of knowledge, the bacon Congressmen are elected to bring home is not more taxes to pay, more interest income to those who, it is suspected, have too much money anyhow.

This the Treasury knows. Consequently it has a perfectly understandable bias in favor of low interest rates, and the bias can be expected to be a function of the relative size of the debt. One will grow as the other grows. Each time the Treasury requires funds, it will accordingly be inclined to a rate on the low side. Furthermore, it will be inclined to short-term securities, which now carry a lower rate, which also means the Treasury is more continuously in the market on refunding operations, which makes Federal Reserve support of the market seem even more essential to the Treasury.

[6] The full effect would, of course, be felt only after sufficient time had elapsed so that all outstanding obligations had been refunded.

[7] Evsey D. Domar, "The Burden of the Debt and the National Income," *American Economic Review*, (December, 1944), p. 800.

The Federal Reserve's dilemma is then posed. They can restrict credit to restrain the boom, which will force rates higher, which means the Treasury's refunding operation fails because its issues are at unattractively low rates, which probably also means a congressional investigation, etc. Or they can assure the success of the Treasury's operations by appropriately easy money, which means easy money for all, which is inflationary during an inflation.

3. Would a rise in interest rates have stopped the inflation? Just how important, in other words, is monetary policy in determining the level of national income. This is really the basic question. The Federal Reserve's skepticism about the potential effectiveness of monetary policy during the postwar period was probably justified to a considerable extent. In that period people were wanting goods badly, and they could pay for them. This simply added up to a volume of effective demand out of any reasonable relationship to our capacity to produce, and any reasonably restrictive monetary policy probably could not have pruned it back sufficiently.

a) In part, however, this skepticism probably reflected also the increasing reservations developing prior to the war about the extent to which interest rates were after all a very important part of spending and saving decisions. They did not seem, in the short run at least, to have much effect on consumer spending out of income. Nor did it seem probable that a change of a per cent or so in interest rates would be important to a business contemplating an investment outlay. This line of analysis has tended, I think, to take too narrow a view of the phenomenon in question, and this has not served us well in the postwar period.

It is essential to remember that when we used the term interest rates, we were really using a sort of symbolic shorthand to cover the whole phenomenon of availability of funds. But then we tended to forget that the term interest rates was merely a symbol, started analyzing the symbol as the substance, and came to the not surprising conclusion that it was not a very important determinant of the level of business activity. We thereby overlooked the fact that the phenomenon of rising interest rates means a great deal more than just charging the borrowing customer a half per cent more or so on a loan. It means that loan applications get more careful scrutiny. Some get pruned down. Others are turned down altogether, which would earlier have been granted. Financial institutions on investment account begin to pursue a wait-and-see

attitude, with the result that new issues become difficult to float on favorable terms. The increasing institutionalization of personal savings means that their availability to borrowers has become extremely sensitive to prospective changes in interest rates. Thus, savings out of income (i.e., the position of the consumption function) may be little affected by interest rate changes, but the availability of the savings to borrowers is very much affected, probably more so than in the past.

b) A large part of our difficulties in pursuing a restrictive monetary policy during the postwar boom stemmed from our having forgotten, or at least unduly underestimated, the significance of some sort of a Wicksellian concept of a normal rate of interest. Wicksell defined the normal rate of interest, you will recall, as simply "the rate of interest at which the demand for loan capital and the supply of savings agree . . ."[8] On the one side is the demand for loan capital on the part of those households and firms with ex ante deficits. They expect to spend beyond incomes. This total demand for loan capital represents expected deficits in the budgets of households and firms which require financing. For these units outlays are expected to exceed receipts by the extent of deficits.

These deficits require financing. In equilibrium an interest rate is arrived at which equates the extent to which the deficit spenders spend in excess of income with the extent to which the savers spend short of income. Total spending, and therefore the level of national income, is just sustained. The excess spending of the "defiicit" spenders is just offset by the "not-spending" of the savers. The demand for loan capital and the supply of savings are equal, with the interest rate representing the intensity of the pressure of the one against the other. The rate of interest, to use one of Professor Schumpeter's phrases, represents the "coefficient of tension" in the system — the intensity of demand for present balances to finance deficits.[9]

In the postwar inflation the magnitude of these deficits was not subject to the constraint of the volume of "not-spending" by the savers. Almost everybody was trying to push spending ahead of income. This normally would have resulted in an accentuated pressure of deficits against the limited volume of ex ante savings.

[8] Knut Wicksell, *Lectures on Political Economy*, Vol. II, *Money* (London: Routledge, English edition, 1935), p. 193.

[9] J. A. Schumpeter, *Business Cycles* (New York: McGraw-Hill, 1939), p. 126.

The "coefficient of tension" would have mounted and only the more urgent deficits would have materialized.

But deficits in the postwar period were very readily financed in all sorts of ways. Bonds could be unloaded at attractively supported prices. Or a moderately higher rate than on government securities tempted prospective lenders to dump government securities and take on non-government earning assets. The rate at which funds could be obtained was substantially lower than the normal rate—defined as the rate at which the demand for loan capital and the supply of savings are equal. In Wicksellian terms the monetary rate was below the normal rate. Ex ante deficits were in excess of savings, and on each successive "round" aggregate spending rose.

The moral of the story is: *The position of the monetary rate relative to the normal rate is, after all, important.* We may disagree as to whether the monetary rate's agility is very sufficient to keep it close to the normal rate, but we overlook at our peril the fact that the normal rate *does* exist. My own view is that the monetary rate, if within its ambit is included (as it should be) the whole concept of the terms of availability of funds, is given credit for less agility than it actually possesses.

One condition was, however, involved in this process—that the government obligations could be unloaded. This implied that there was something to unload them on, and that unhappy institution in the postwar period was the Federal Reserve. The arrears of consumer and business capital meant a high normal rate. An appropriately high monetary rate meant low bond prices. Sustained bond prices meant a low monetary rate, spending continuously accelerating, and more price inflation. There was the dilemma of the postwar boom.

c) There are two implications of this which are worth mentioning here. A wartime rate structure should be set with particular regard to whether it will be tenable in the postwar period. Wartime stability of rates, essential as that may be, is a secondary issue. With the elaborate direct controls, and a strongly organized central or reserve banking system, almost any reasonable rate structure can be maintained during the war. The real question is whether the terms of obligations issued during the war will be *reasonably* articulated with the postwar economic facts of life—to be specific, the Wicksellian normal rate. It may, in other words, be desirable to finance the war at rates higher than necessary incident to war financing if the existence of the debt is not to serve as

a major instrument of inflation in the postwar period. The rate structure of World War II was on the contrary more nearly retrospective—geared to the depression developments of the prewar decade. Rates were thus about two notches below an appropriate level in the postwar period.

But the main significance of this side-trip into theory is that interest rates on government obligations, long-term as well as short-term, may be persistently below the normal rate. If so, very important questions are posed. We may not know the answers but there is little disposition to doubt that the questions exist, and that they are very real questions. Will the demands of our economy on consumer account, investment account, foreign account, and government account add up to a chronic tendency for ex ante deficits to be in excess of savings? If so, yield rates on government obligations must rise, or the alternative will be abetting upward pressure on prices. But more of this in a moment.

III

1. What we have witnessed here, of course, is the progressive sterilization of monetary policy by fiscal and debt management policy. That is, I think, increasingly generally recognized.[10] What may not have been so obvious is that this inability to pursue a restrictive monetary policy during a boom may also be going a long way toward neutralizing an effectively restrictive fiscal policy. The restrictive effect of a governmental cash surplus, for example, may largely be lost if households and firms can bail themselves out of this limitation by borrowing or by ready sales of government securities. We get, in other words, a chain reaction. Monetary policy is immobilized because of the apparent requirements of fiscal and debt management policy. This immobilization in turn tends to neutralize the effectiveness of fiscal policy.

The substantial corporation income tax in and of itself, for example, undoubtedly constituted some restriction on these firms' postwar expansion plans. On the other hand the effect was materially blunted because corporations had recourse to a liquidation of government securities from 1945 to 1948 of $7.2 billions plus substantial bank borrowing to offset this constraint, and it was unquestionably a substantial offset.[11]

[10] For some prophetic words on this point see D. H. Robertson, *Essays in Monetary Theory* (London: Staples, 1946), p. 131.

[11] "Working Capital of U. S. Corporations," June 30, 1949, Securities and Exchange Commission Release No. 892.

Now this inability of monetary policy to come to grips with a boom has been a rather bizarre finale to the story. The shift in emphasis *to* fiscal policy in the prewar decade was thought to be precisely because it was not a boom, but a depression with which we then had to deal. Monetary policy was considered to be effective certainly and appropriate probably (there was less agreement on that point) to check a boom. "The monetary weapons can, indeed, be applied effectively to check an expansion," stated Professor Hansen, probably summarizing prevailing opinion on the subject.[12]

What started out as a procedure to gain the initiative in a depression seems to have resulted in our losing the initiative in the boom also.

2. It may be argued that this less than delightful turn of events policy-wise stems not from the operation of fiscal policy, but simply from the war legacy of a huge public debt that had to be managed. There is, of course, much force to this argument. The debt certainly grew at a rate which was never contemplated in the more responsible deficit-spending discussions about the affirmative use of fiscal policy to combat depressions. On the other hand the point should not be overemphasized.

In our discussions of fiscal policy in the prewar decade we were quite evidently prepared to think that a necessarily vigorous exercise of fiscal policy might well lead to a considerably larger public debt. With that in mind a great deal of our thinking regarding fiscal policy had to do with precisely this question of the burden of a domestically held debt. Particularly was this possibility of a substantial rise in the public debt an explicit part of our thinking in connection with the mature economy thesis. It is difficult to believe, therefore, that the war debt poses any fundamentally new problems which we might otherwise never have had to face. There is, on the contrary, a great deal of reason to think they would have faced us in any event anyhow.

3. A further question may be raised as to whether a great deal of this is not water over the dam since the announced change of policy in June of this year. At that time, as mentioned earlier, the Federal Reserve took advantage of the fact that market strength had lifted bond prices off the support levels to announce that:

[12] Alvin H. Hansen, *Fiscal Policy and Business Cycles* (New York: W. W. Norton & Company, Inc., 1941), p. 71.

"The Federal Open Market Committee, after consultation with the Treasury, announced today that with a view to increasing the supply of funds available in the market to meet the needs of commerce, business, and agriculture it will be the policy of the Committee to direct purchases, sales, and exchanges of Government securities by the Federal Reserve Banks *with primary regard to the general business and credit situation.* The policy of maintaining orderly conditions in the Government security market, and the confidence of investors in Government bonds, will be continued. *Under present conditions* the maintenance of a relatively fixed pattern of rates has the undesirable effect of absorbing reserves from the market *at a time when the availability of credit should be increased.*"[13]

Does this not mean that monetary policy's indenture to fiscal and debt management policy is concluded, and that monetary policy will again pursue its more historic function of having to do with general economic stability? Perhaps. It is to be hoped that this constitutes a substantial step in that direction. There is, however, reason for being less than certain about how fundamental the change really may turn out to be.

The "policy of maintaining orderly conditions in the Government security market" and encouraging "confidence of investors in Government bonds," which is to be continued, was the *point d'appui* for the monetary problems which bedeviled us during the postwar boom. The question still remains, therefore, as to how differently we might wind up again if we were to experience another substantial boom, since we would be starting from about the same point.

The real question is whether the June announcement constituted a recognition of changed conditions or whether it represented a fundamental change of policy. The final sentence of the release indicates that the former was presumably a substantial consideration. With the inventory recession, private demand for credit began to weaken. Funds seeking investment were turning more toward government securities, and the resulting market strength carried their prices off the pegs. The pegs consequently could rather readily be removed without our having to face the implications of a freer market for government securities with higher rates. In fact, prior to June this year the Federal Reserve, in

[13] "Press Release of June 28, 1949," *Federal Reserve Bulletin*, (July, 1949), p. 776 (italics mine).

endeavoring to support the stipulated price levels, found themselves selling securities in response to market demand — a policy which had the effect of holding interest rates up during a recession.

The real test of the extent to which there has been a substantive change of policy will come with the next business upsurge. Private demand for credit will then be strong, and funds will start shifting out of governments and into higher yielding non-government earning assets. Prices of government securities can then be expected to sag, and the conflict between debt management policy and "primary regard to the general business and credit situation" will then be posed in a way which it is not posed in a recession. Will "orderly conditions" be interpreted then as preventing only a cumulative speculative collapse of government security prices, although allowing them to fall to some sort of equilibrium level, even if that should be below par? The answer is by no means a self-evident yes.

In his remarkably candid December 1, 1949, letter to Senator Douglas, Mr. Eccles suggests that he, at least, also does not feel that the Federal Reserve is as yet in a position to pursue a sufficiently restrictive money policy in the event of inflationary pressures. In his letter, written early this month, he cogently argues:

"Under these conditions it can hardly be said that the Federal Reserve System retains any effective influence in its own right over the supply of money in the country or over the availability and cost of credit, although these are the major duties for which the System has statutory responsibility. Nor can it be said that the discount rate and open market operations of the System are determined by Federal Reserve authorities, except in form. They are predetermined by debt-management decisions made by the Treasury. This will be true as long as the System is not in a position to pursue an independent policy, but must support in the market any program of financing adopted by the Treasury even though the program may be inconsistent with the monetary and credit policies the System considers appropriate in the public interest."[14]

[14] *Statement of Marriner S. Eccles before the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, November 22, 1949, and Supplementary Letter to Senator Douglas of December 1, 1949* (Washington: Federal Reserve Board of Governors), p. 7.

4. This emergent dominance of debt management policy is sometimes described as a Treasury-Federal Reserve or Federal Reserve-Lending Agencies conflict. There is no question but that these seem to be the principals. It seems to me, however, that to characterize it in this manner is to describe the symptom rather than the substance. The problem is more basic. It represents a lack of articulation in our total economic and social policy measures and objectives. By and large we liked almost everything about a period of rising prices, except rising prices. The feeling of excess demand for practically everything was particularly comfortable in view of our legacy of depression-mindedness.

The postwar boom illustrates this well. Were some people's housing needs not being met? Was it because people could not pay the prices? Very simple. Let them borrow more — 100 per cent, if necessary. Did that make the monthly terms too high? Equally simple. Extend the period; lower the rates. And it was done.

Were taxes a constraint on spending? Then Congress must lower them. And it did.

Was the burden of paying interest on the debt apt to be onerous? The solution? Well, the interest on a debt twice as big is the same if interest rates are half as high. Let the Treasury keep that in mind. And it did.

Is a bond more valuable at par than below par? Then let the Federal Reserve know it is expected to keep them at par. And it did.

This could be expected to add up to an economic situation that did not particularly please anyone. And it did.

In short, until we have made more clear, and perhaps seen more clearly ourselves, cause-and-effect interrelationships, the ramifications of some of these policies, we can certainly expect a continuation of the demand to have our cake and eat it too.

We shall again in a boom insist on low prices and then keep them higher through low interest rates. We shall continue to demand lower construction costs and then force them up with more generous mortgages. And the apparent altercations between the Federal Reserve and the Treasury or the Federal Reserve and the various other lending agencies will be little more than a reflection of our own inability to arrive at a seasoned, mature, responsible, and reasonably consistent economic policy.

Something might, I think, be accomplished by the formation of a National Monetary Council, as recommended by the Hoover Commission, composed of representatives of the Federal Reserve, the Treasury, and other regulatory and lending agencies. In this way a formal, organized procedure for airing all points of view (particularly the Federal Reserve's) would be provided, and the probability of agencies being oblivious to contradictory policies might be minimized. This would be all to the good, and might result in some greater consistency of policy.[15]

We should not, however, expect too much from it. If these intra-agency conflicts are largely reflections of internal contradictions within our total social and economic policy, they will not be liquidated by appointing the contending principals to the same committee.

In the final analysis our success in dealing with this problem is going to depend largely on how clearly Congress and public opinion see the implications of available alternatives. So far as debt management and monetary policy are concerned, there are three.

a) We can continue as at present with the Treasury largely the architect of monetary policy through decisions on the terms and rates of public debt issues, and with the Federal Reserve taking the necessary action to implement these decisions. This means the continuation of low interest rates, not only for the public debt, but generally. More importantly, it means only a negligible monetary defense against upward price pressures, through the maintenance of a monetary rate below the normal rate.

b) If we insist that something be done monetary-wise in case of inflationary developments, but are unwilling to permit higher rates or adequate flexibility in government security prices (which may mean below-par prices) we must then be prepared to accept a possibly increasingly complex method of forcing holders of bonds to hold their bonds.[16] The special reserve proposal outlined by the Federal Reserve in 1947 points one way—the proposal that banks be forced to hold a designated proportion of their assets in certain government securities. It will not be enough, however, to apply it merely to banks. Other holders must be included also. It is well not to forget for example, that holdings of government securities by insurance companies declined $3.8 billions during 1947 and 1948. Theoretically *all* holders, *including individuals*, should under

[15] G. L. Bach, "The Federal Reserve and Monetary Policy Formation," *American Economic Review*, (December, 1949), p. 1189.

these circumstances be required to hold obligations up to some designated amount.

The issue here is simple. If the terms of the government obligations are not sufficiently attractive to induce their being held voluntarily, people must be required to hold them involuntarily.

c) We can reactivate the Federal Reserve mandate to determine monetary and credit policy with respect to the general economic situation. This means, among other things, we must be prepared to see some more flexibility in bond prices, in order that the relationship between the monetary rate (availability of funds) and the normal rate will be more consistent with broad economic policies.

The most difficult question, of course, is whether the degree of flexibility required to exercise monetary restraint (particularly if below-par prices were required) would precipitate an unacceptably disorganized market. It may be that more of the public debt will need to be refunded into non-marketable securities with redemption before maturity subject to a penalty discount, or perhaps consols the Federal Reserve will explicitly make no attempt to support.

The degree of flexibility contemplated even so would not presumably be very vast. The institutionalization of savings, together with the size of the public debt "have made the money market much more sensitive to relatively modest action than was formerly the case."[17] This does not, in short, mean the Federal Reserve should during inflation kick the props out and "let 'er rip." It is to be hoped that discouraging disorderly and disorganized developments in the bond market does not need to mean fairly rigid support—that there is no compromise between a chaotic and a frozen market. It must, however, be admitted that in the practical operation of monetary policy this distinction is both extremely necessary and extremely difficult to make.

This does not mean that monetary policy is expected by itself to solve the riddle of economic stability. It does mean that it be free to operate in the right direction, rather than in the direction of being unable to restrain the boom and at the same time neutral-

[16] Woodlief Thomas and Ralph A. Young, *Problems of Postwar Monetary Policy*, "Postwar Economic Studies," (Board of Governors of the Federal Reserve System, November, 1947); "Proposal for Special Reserve Requirement against the Demand and Time Deposits of Banks," *Federal Reserve Bulletin*, (January, 1948), pp. 14-23.

izing a restrictive fiscal policy, as is quite possible under present conditions.

The third alternative does mean, in short, responsibly engineering that degree of flexibility in yield rates which will in fact demonstrate that the public debt is not a slightly sophisticated greenbackism, and will encourage holders of government obligations to understand that their bonds are not to be considered as practically cash.

IV

If we can regain somewhat more initiative with respect to monetary policy, we shall not then need to rely quite so exclusively on fiscal policy. This is all to the good—not because fiscal policy is bad, but because it is always better to work from more than one angle if possible. Moreover, it may be essential to gain somewhat more initiative with monetary policy if fiscal policy, particularly in a boom, is not also to be neutralized.

By fiscal policy I mean simply the impact on the volume of economic activity of the governmental receipts-spending process. There would be general agreement, I think, that this impact is apt to be quite substantial for some time to come. To this even those who are made somewhat uncomfortable by the prospect would probably agree. It seems to follow that if the effect is going to be quite substantial in any case, it should, where possible, work in the right direction.

As the economists, meeting under the auspices of the National Planning Association, have very cogently pointed out: "If we do not adopt such a policy deliberately we are likely to be forced into an imperfect version of it through the pressure of events."[18] This means that when private demand and spending is weak, the governmental receipts-spending process should help things out. This it can do either by dipping less taxes out of the income stream, and thus encouraging private spending, or by stepping up its own spending, and thus supplementing private demand (spending). During a boom, the process should work the other way around.

The affirmative theory of the thing has been worked out in considerable detail, and is almost a part of the lore of economic policy.

[17] Allan Sproul, "Monetary Management and Credit Control," *Monthly Review*, Supplement, Federal Reserve Bank of New York, January, 1947), p. 6.

[18] Hearing before the Joint Committee on the Economic Report, September 23, 1949, p. 7.

I do not propose to try to add anything here along that line. I do not believe our difficulties in the more expert operation of compensatory fiscal policy arise out of any serious lack in the development of the theoretical principles. On the other hand, even those who have been very sympathetic with what it might contribute to economic stability, of which I am one, have become increasingly disturbed by certain other questions. My own view is that satisfactory answers to these questions must be found before we can proceed much farther in the use of compensatory fiscal policy. It may be useful to pose a few of them here.

1. Can we find ways to minimize some very real limitations to a variable spending policy?

a) Just as emphasis early was primarily, though by no means entirely, on public spending, so also some of our early uneasiness has had to do with how readily in practice the volume of public spending could be altered in a contracyclical manner. So far as public works spending is concerned, the construction industry has long been recognized as too narrow a funnel to pour in an amount of spending which might be necessary in a substantial general business decline. What might rather be aimed at would be a sufficiently contracyclical pattern of public works spending to encourage greater stability in the construction industry. Since it has traditionally been one of the more volatile sectors of the economy, this would be no mean contribution to stability generally.

b) One of the more serious questions about a compensatory spending program is how to make sure it increases employment and production rather than prices and costs. We found early in the defense and war program that a cost-price inflation began to develop long before we had reached a reasonable maximum of production and employment. To be specific, the wholesale price index during 1941 advanced 13 percentage points (16 per cent) even though unemployment averaged 5.6 million during the year. Our experience was somewhat similar during the 1936-37 boomlet, though the picture was complicated by the wage increases incident to labor's organizing some of the basic industries.

Perhaps some part of the trouble then was that we had operated too long at low-production levels. Inadequate capacity in some industries bottlenecked the general expansion and forced prices up before full production could be achieved. If so, the problem should be less serious in the period ahead since the various segments of the economy are better geared to high-production levels.

My own view is, however, that this will be more than offset by the greater power of organized labor to force up wage rates in excess of rising rates of productivity—thus leaving the problem of a cost-price inflation still very much with us.

c) But the most difficult problem incident to a contracyclical spending program has to do with the hard question of timing. It has generally been argued that these measures should be launched fairly shortly after the beginning of the decline. This seems to be a very reasonable proposition, but it is exceedingly difficult to put into practice. It is simply not easy to know very promptly just where we are in the cycle. A review of some of our past discretionary policy actions, most of which have to do with other things than the timing of expenditures, is very illuminating on this point.

There is, of course, the President's Economic Report to Congress transmitted in January, 1949. The report was largely oriented about "policies to Combat Inflation. . . ."[19] From these policies we were saved by what has often been considered a major obstacle to a rational contracyclical program—the considerable time it takes Congress to act. By January, it is now evident, we were well along on the 1949 inventory recession, the wholesale price index had been declining for five successive months (the peak was in August, 1948), and unemployment had been rising after October.

The Federal Reserve, rightly credited with somewhat greater agility, has had a somewhat similar experience. Their request of Congress for reimposition of Regulation W (consumer credit control) and additional powers over member bank reserves was made in August, 1948, the final month of the price rise. Congress acted with unusual speed, and the anti-inflation powers were inposed beginning in September, after the price level had begun its decline. It must, of course, be said that the Federal Reserve did reverse itself with reasonably commendable promptness in 1949.

Though it is not usually rated highly by economists, there is considerable reason to think that the best-timed performance in discretionary, compensatory fiscal policy was the May, 1948, tax reduction—nonetheless expertly timed because its proponents were not known to be devoted to the New Economics. It came just four months before the beginning of the price decline, and the refunds

[19] The Economic Report of the President transmitted to Congress, January, 1949, p. 11.

were paid out early in 1949 after the recession was getting underway.

I do not cite these in an sense as criticisms of institutions or individuals. In each case there was recourse to eminently qualified and able experts. Rather these experiences serve to show how extremely difficult it is to know where you are. But until we can do better at this, we cannot expect to do very well in prompt and effective timing of discretionary policy actions.

2. These considerations have turned our attention increasingly to the concept of built-in stability. The Committee for Economic Development, among others, has done a great deal to educate us on this point. The idea is basically quite forthright.[20] "Set tax rates to balance the budget and provide a surplus for debt retirement at an agreed high level of employment and national income. Having set these rates, leave them alone unless there is some major change in national policy or condition of national life."[21]

a) This has two advantages. It largely avoids the difficult timing problem. As national income declines, a cash deficit automatically develops because, with our progressive tax structure, tax receipts decline rapidly and certain outlays (e. g., unemployment compensation) automatically rise. Conversely, tax receipts rise relatively to expenditures on the upswing and the surplus grows as the need for it grows. The economic process is subject to a sort of governor that tends to control the speed of operation.

It relies more heavily on sustaining private spending rather than compensating for its deficiency through added governmental or collective spending.

b) With the rapid development of social insurance programs and our currently substantially progressive tax structure, we have already accomplished a great deal along this line. A correlation of disposable personal income with gross national product shows that for the period of 1929-37 (covering the decline and recovery, but before Social Security had become important), the regression equation is Y_d=2.805+.769 GNP. For 1939-41, on the basis of seasonally adjusted quarterly data, the equation is Y_d=12.392+.629 GNP; and for the five quarters, 1948 third quarter to 1949 third quarter, Y_d=118.90+.2868 GNP. These are subject to numerous

[20] *Monetary and Fiscal Policy for Greater Economic Stability*, Committee for Economic Development, December, 1948, p. 38.

[21] "Taxes and the Budget," Committee for Economic Development, 1947. Quoted in the 1948 report cited above.

limitations. A considerable dispersion is probably inevitable. The number of observations is small. The postwar period has been subject to special influences. It is not always easy to separate periods in order to distinguish the effects of a changed tax structure from a change in the tax structure.

Even so, the evidence seems to me to be reasonably clear that disposable personal income has become less and less sensitive to changes in the level of general business activity. Each successive period's coefficient of regression is lower than the preceding one. For 1929-37 a change of one dollar in gross national product was associated with a change of 77 cents in disposable personal income; in 1939-41 it was one dollar to 63 cents; and during the five most recent quarters for which data are available, it has been one dollar to 23 cents. (Perhaps here is a substantial part of the reason the 1949 recession was so mild.)

c) There are three major limitations to which this governor-like arrangement is subject and which deserve mention here.

(1) A recession may be sharp enough that more powerful action is required. The Committee for Economic Development recognized that in these circumstances "a temporary reduction of tax rates may be desirable to stimulate private expenditures."[22]

(2) Taking less of incomes in taxes undoubtedly encourages greater private spending, but it does not guarantee it. Even if the consumption function does not decline, larger deficits may be required than with public spending since a part of each added income dollar is usually saved (the marginal propensity to save is greater than zero).

(3) There is a basic conflict between the concept of built-in stability and economic progress if the former is pushed too far. This governor mechanism works most effectively, of course, when the tax take is extremely sensitive to changes in the level of national income. This means that a correspondingly substantial proportion of each *added* national income dollar must go in taxes. This also means that the net difference between mediocrity and doing things better is diminished in a parallel manner. There is unquestionably considerable room for disagreement as to just how far we can go along this line before economic progress is jeopardized; there is less room for argument that the problem exists.

3. Has compensatory fiscal policy tended to divert our attention from very real economic maladjustments in the economy? I think

[22] *Monetary and Fiscal Policy for Greater Economic Stability*, p. 33.

it has had that result. I do not mean by this to suggest that the business cycle is primarily a matter of economic disease rather than "real" factors such as fluctuations in investment incident to innovations. Nevertheless in any particular situation maladjustments may be a large part of the problem. Let me cite a few illustrations of what I mean.

a) The Great Depression was a great depression largely because of the 1931 to 1933 phase. This, in retrospect, presents itself as largely a sort of pathological monetary panic. In less than two years following mid-1931 we lost one-third (7,000) of our banks and through credit contraction extinguished $15 billion of our money supply! These are little short of fantastic figures. It would require no concept of a chronically weak marginal efficiency of capital to explain why we went so low—or why for the better part of a decade thereafter we seemed to be plagued by a condition of almost absolute liquidity preference. The Great Depression was a great depression largely because of a specific maladjustment—the vulnerability of our banking system.

b) One of the particularly disappointing features of the recovery after 1933 was the continued low level of private construction. Private construction activity made no significant recovery until 1936, in which year it was 33 per cent of 1929. (The 1936 gross national product was 79 per cent.) It may have been that we were in the wrong phase of the eighteen-year construction cycle; there is some evidence that we were. Nevertheless, in the period from July, 1936 to September, 1937, a period of general unemployment, particularly low construction activity, and during which time we were trying to encourage recovery through public works spending, construction costs as indicated by the E.N.R. construction cost index increased 22 per cent, and Boeckh's indexes of residential construction costs for the four listed cities registered increases up to 19 per cent.

c) The same questions can be raised about the public housing assistance currently. Instead of floating the industry off the rocks with public assistance, it might have been the better part of wise economic policy first to see why the industry could not operate more effectively in a period of substantial latent demand and easy money. Is there labor-management collusion? What about local monopolies of materials? Building codes? We would probably have wanted a substantial public housing program in any case. If so, it could have been just that much more effective if the

industry itself were placed in a position to give more for the money.

4. Have we given adequate attention to the significance of the size of the budget, even if balanced?

The fact that government outlays have increased, or are large, is not necessarily a cause for alarm. In a very real sense it is a measure of our development above the jungle economy. We can now afford certain social programs, always desirable but heretofore out of reach. Moreover, many of these outlays open up or facilitate private economic development. The automobile industry could not have attained its present proportions had we been unwilling to do some of our spending collectively to build a road system.

A large relative volume of governmental outlays does, however, pose some problems, and economic statesmanship requires that we be willing to face them.

a) Beyond a certain point, to the extent that we spend our incomes collectively through the agency of government the less we shall have to spend individually. If we have more battleships, we may have fewer cars. If we have more collection of statistics, we may have less to collect statistics about.

b) As the relative size of governmental outlays expands, there results greater upward pressure on the demand side even if the budget is balanced. For any individual what he gets through government is not subject to the budgetary or income restraint that the more he gets the bigger the bill. The rules of the game encourage pressing for more. What is true for one is true for all. The price tags tend to be removed, and payment becomes a separate consideration.

The issue is particularly clearcut if through progressive or corporate income taxes we can apparently shift the burden to others—thereby perhaps also helping those who presumably have too much anyway to squeeze a bit more readily through the needle's eye. It is imputing no bad motives to people to say that with this payment constraint removed or diminished, total demand tends to rise. The advantage of each separate governmental outlay tends to be concentrated on a particular group, but the cost is diffused over the whole society. Each separate project thus seems to be a "good deal." The fact that it adds up to a volume of total outlays about which nobody is very happy is not too difficult to under-

stand. The result is an upward bias on demand that becomes progressively more important as collective consumption and income transfers (governmental outlays) represent a larger proportion of the economy.

c) How serious this is depends on the collateral effect a large governmental budget (even if balanced) has on our capacity for economic growth and progress. We can easily take this matter of rising productivity too casually—as something that, like old age and maturity, more or less occurs with the passing of the years. This is not necessarily the case. Productivity has increased because ways have been found to make an hour of human endeavor turn out progressively more and more of the good things of life without harder work.

While governmental outlays at 23 per cent of our gross national income are probably not at the peril point, they are large enough to make a consideration of these issues in order. Particularly is this so with the current tendency to extrapolate future demands on the economy on the assumption that our 2 to 3 per cent per year rise in productivity will continue.

Beyond some point a large budget will begin to inhibit this process in two distinct ways.

(1) One source of rising productivity is the myriad of ways, little and big, that are constantly being discovered to cut corners on costs and improve earnings. And their aggregate effect is the socially very desirable result of making productive resources go further. As taxes rise relative to incomes the net difference between the rewards of those who watch costs and those who do not is reduced. And one of the results of this is to weaken one of the economic pressures toward increasing productivity, toward more effective use of resources.

(2) Moreover the net advantage to the firm which reduces costs or introduces a new product through an investment program is also correspondingly reduced relative to the firm which does not so exert itself. Yet capital formation has been a second major source of our rising productivity. To the extent that firms must rely on retained earnings to finance capital outlays, this consideration becomes particularly important. Then the inducement and the capacity to invest are both inhibited as taxes bite more and more deeply into corporate income. Whatever the merits otherwise of these taxes, one result is apt to be a corresponding stifling of investment and a reduced rate of economic progress.

These tendencies are particularly pronounced with the substantially progressive character of our tax structure,—which paradoxically is one of the reasons we can rely heavily on built-in stabilizers. There are certainly sound, impressive reasons of social justice for a considerable progressivity in our tax structure. This does, however, have the unfortunate effect of coming down particularly hard on activities which add to income. Yet those who are not content to let well enough alone are those whose innovations and activities make a particular contribution to economic progress. This does not seem to be the proper avenue to rising productivity. We cannot, in short, dodge this question: How far can we afford to go in championing those content with things as they are and penalizing those who try for something better?

We shall, in short, need to take care that the very thing we count on to enable a continued expansion of social programs does not become their victim—rising productivity.

V

At the present stage of monetary and fiscal policy the major questions with which we must come to grips, it seems to me, are therefore these:

1. How far are we prepared to go toward a reorientation of monetary policy away from debt management considerations and toward general economic stability? Can adequate procedures be devised to facilitate this reorientation?

2. Is there a clear understanding of the implications of the alternatives?

3. Do we see that the cost of excessively rigid yield rates and prices of government securities may be devices to force holders of bonds to hold their bonds, if monetary policy is not to be both ineffectual itself to restrain a boom and a substantial drag also on an effective fiscal policy?

4. Can we avoid or minimize certain very real current limitations to the greater use of the governmental receipts-expenditure process in stabilizing business activity—its tendency to raise prices and costs before an optimum level of production and employment is attained; its tendency to divert attention away from specific maladjustments; the difficulty of timing?

5. Do we need to give more attention to the effect of these and related policies on our rate of economic expansion and progress?

This last question is, I think, particularly important. One sometimes has the uncomfortable feeling that we are devoting a considerable proportion of our time to St. Vitus' dance, so to speak, when an emerging problem of at least equal importance may be how to avoid economic arthritis.

DIRECT VS. FISCAL-MONETARY CONTROLS: A CRITIQUE[1]

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When the old farmer heard the word "prose" for the first time, the word had a strange sound, and it was a shock to him to realize that he had been talking prose all his life. Perhaps the first observation that should be made, in an analysis of the use of direct *versus* fiscal-monetary controls, is that the society in which we live has been using direct controls in peacetime, to affect economic activity, for a long time. Among the most elementary examples is the prohibition of certain gainful occupations, for example, robbery and counterfeiting. Or consider child labor laws, the control of agricultural production which is a part of the farm price support program, or the regulation of public utility corporations. It is therefore pertinent to note that what is in point in today's discussion is not the use of direct vs. fiscal-monetary controls for economic ends in general—for no one on sober thought would deny the desirability of direct controls for certain economic purposes—but the use of these alternative types of control specifically to control the level either of employment or of prices.

Fiscal and monetary controls are indirect controls. By indirect controls, in this context, I refer to measures which attempt to influence actions by creating economic compulsions or inducements without introducing legal compulsions *concerning those actions*. By direct controls I mean controls which attempt to influence actions by establishing legal compulsions concerning them. For purposes of economic stabilization (though not for other purposes), I think fiscal-monetary controls are the only type of indirect controls, so that the two classes, fiscal-monetary and direct, are exhaustive. "Fiscal-monetary" here of course includes the types of measures generally referred to as revenue, public expenditure, public debt management, monetary, and banking measures. The archetypes of direct controls are price control and rationing, including in both terms the control of productive services as well as of goods at all stages in the productive process.

Comparison of the use of direct and fiscal-monetary controls for purposes of economic stabilization may be confined to the case of checking inflation. The compelling arguments against the use of

[1] I am obligated to colleagues in the Department of Economics at the University of Illinois for criticisms from which the present draft of this paper benefited greatly.

direct controls to prevent deflation or unemployment are, I think, obvious.[2]

The use of direct controls to the exclusion of fiscal-monetary ones, for the purpose of checking inflation or for any other economic stabilization purpose, is really not in point. Fiscal and monetary controls will exist in any economic system which it is relevant for me to consider; and these controls will affect the level of economic activity and of prices, whether or not they are designed to do so. What is in question is whether the use of fiscal and monetary controls adequate in themselves to prevent inflation is desirable, or whether less stringent fiscal-monetary controls, supplemented by direct controls, should be used. This is the situation I shall have in mind, when I refer to the use of direct controls.

II

The case commonly made against the use of direct controls to affect productive activities may be stated simply: they interfere with productive efficiency; they are costly, in the economic rather than merely in the financial sense, to administer; and, except when applied to correct the distortions caused by private monopoly, they themselves distort the allocation of productive resources. In these ways, they reduce output, that is, they reduce the utility or satisfaction created in the productive process.[3]

Assuming for the moment that permanent or at least fairly long-lasting controls are in question, these arguments must, I think, be accepted with little qualification. Concerning controls adopted to regulate some specific small sector of the economy, these effects may be of little importance; but in the case of widespread controls, such as the general controls intended to check or prevent inflation, these effects are of major concern.

[2] That they have not always seemed obvious to all economists is evidenced by discussions pursuant to enactment of the National Recovery Act. They perhaps do not now seem obvious to all economists.

[3] It is also argued that direct controls simply transfer the inflationary pressures from the market to the control authorities, who may not be able to withstand organized group pressures. This amounts to saying either that direct controls will not be effective, or that the cost of effective direct controls will be excessive. The latter argument is accepted below as sound, *ceteris paribus*. The former implies a judgment that fiscal-monetary controls are more apt to be politically palatable than direct controls. Concerning this complex question, two things can be said: (1) recent United States history offers no evidence of the general correctness of the statement; (2) the relative palatability of fiscal-monetary and direct controls probably depends upon the specific social circumstances. The discussion below attempts to offer a clue concerning the circumstances which must be taken into account.

Direct controls lessen productive efficiency by in some degree lessening incentives. Rationing prevents the consumer from maximizing his real income by preventing him from allocating his money income among saving and various types of consumption in the way which is optimum in view of existing prices; price control prevents the allocation which would be optimum in view of existing supplies of goods. Specifically, either forces on him a rate of money saving which he would not choose in the absence of the controls. Either, unless it is assumed to be short-lived, must therefore lessen to some degree the incentive to maximize money income; and even if short-lived will do so if the share of total income which is unspendable becomes too large.

Moreover, for wage-and-salary earners or profit-receivers either type of control is apt directly or indirectly to set a limit on money income. Wage controls do so directly; price controls, if they are to have any rationale, must in some degree be profit controls, and will come to be recognized as such. Materials allocation may indirectly have similar effects; and general allocation is in any case apt to require price control for its effective enforcement (just as the reverse also holds true; price control requires rationing).[4] Such absolute limitation on income certainly diminishes incentive, thus *ceteris paribus* must diminish both current output and the rate of improvement in productive methods.

Moreover, the cost in effort of enforcement of price control and rationing is far greater than that of fiscal-monetary controls.[5] The mechanisms by which fiscal-monetary controls are administered exist in any case, quite apart from problems of economic stabilization, so that the marginal cost of using them for this purpose is slight, whereas new mechanisms must be created, or existing mechanisms extended greatly, for direct controls. Further, direct controls superimpose an added layer of rules upon the price rules which commonly govern choices; hence they are costly in terms of effort for the persons obeying them. Still further, they are costly to administer because they must be applied separately to each type of goods and services, rather than merely to the generalized type of purchasing power which is money.

[4] In either case, an exception is industries where prices are administered and competition imperfect. In such industries, privately administered allocation or price control may take the place of legal compulsions.

[5] This effect may be exaggerated because obedience to direct controls is not imbedded in conventional morals; and this, in the long view, is not a fundamental consideration, for usage may alter mores.

The third leg of the argument against direct controls is that they result in an uneconomic allocation of resources. The reasoning involved is, of course, that at least in a static situation in which the optimum degree of competition exists, the allocation of resources is optimum when the marginal rate of substitution between any two resources—or, if you choose, the ratio between the marginal productivity of any two—is equal to the ratio between their prices; for the competition between producers (and between consumers) which brings this equality about brings about in the process the allocation of resources which maximizes welfare. The use of either price controls or rationing prevents competitive bidding up of the price of a relatively scarce resource to a level at which it is no longer scarce and the associated transfer to the most productive uses; permits its continued employment in less productive uses; and forces a corresponding misallocation of other resources which would fall in relative price if the relatively scarce resource were available to replace them.

The acceptance of marginal rate of substitution equal to price as a criterion of optimum allocation of resources in a static situation does not, it should be noted, imply acceptance as optimum of the price relationships which happen to face the economists in the real world at any given time. The distribution of income affects relative demand for various goods, and hence affects prices. Some distribution of (real) income other than the existing one may be judged to be optimum.

It may be possible to move from the existing distributon of real income toward the optimum one by direct controls. If so, the resulting allocation of resources must be regarded as an improved one. But an alternative also exists: there is no economic barrier to achieving by fiscal-monetary controls a distribution of purchasing power corresponding to the distribution of goods and services which would result if the direct controls were used. Doing so would not, however, result in a distribution of goods and services identical with that under direct controls, for every person would be free to select the goods and services he consumes, with no constraint except the size of his income. In general he would not purchase a basket of goods and services identical with that which would be reserved for him by the direct controls, and the basket he selects must of course be regarded as yielding him greater satisfaction. *Whatever the distribution of income deemed to be opti-*

mum, therefore, fiscal-monetary controls are economically preferable to direct controls as a method of reaching it.[6]

This argument, it should be noted, is based upon the premise of existence of the optimum degree of competition,[7] and must be qualified if deviations from this condition exist. If a greater degree of monopoly exists, it distorts the allocation of resources; and it is necessarily true that direct controls could in principle improve that allocation, though the data for estimating what alteration in the existing situation would be an improvement may not exist. The significance of this qualification for stabilization policy will be noted in Part IV.

To these standard arguments against the permanent use of direct controls for economic stabilization should be added another: when direct controls suppress an excess of demand, the accumulation of unspendable savings steadily increases the inflationary pressure, so that the controls *eventually* become self-defeating.

III

These criticisms of the use of general direct controls are, I think, weighty ones. They become unimportant if an inflation which faces the economy is deemed to be more injurious than the direct controls necessary to prevent it would be, and if in addition the use of the fiscal-monetary controls which could prevent it does not seem feasible. Certain political and administrative barriers exist to the effective use of fiscal-monetary controls for economic stabilization—for example, the length of time required for legislative action, the unwillingness of Congress to delegate adequate power for speedy changes in fiscal measures, and the time lags involved in using fiscal and monetary controls even under the most efficient legislative and administrative procedures. (The problem of obtaining enactment of legislation authorizing direct controls also exists.) I have discussed elsewhere the possibility of adapting legislative

[6] If the use of direct controls is politically possible whereas the use of fiscal-monetary controls is not, advice concerning public policy must be based on a judgment whether, considering the long run as well as the immediate present, this advantage of direct controls outweighs their inferiority with respect to administrative costs and the effect on incentives.

Just as fiscal-monetary controls, by affecting the distribution of income, affect demand, so also by affecting costs they affect supply. The most egregious but by no means the only example is excise taxes. By a line of argument parallel to that concerning demand, it may easily be shown that if the effect on supply is regarded as undesirable, changing the fiscal-monetary controls is a better remedy than imposing direct controls.

[7] Which is not necessarily perfect competition? See below, IV.

and administrative procedures so as to make feasible the use of fiscal-monetary measures for economic stabilization.[8] The present discussion will assume that this can be done.

But even on this assumption, the considerations which suggest the marked superiority of fiscal-monetary over direct controls need scrutiny, for they seem to run contrary to the evidence of experience. We have recently passed through a war period when, I think every dispassionate observer agrees, the general application of direct controls was indispensable in the interest of the most advantageous functioning of the economic system. Though many economists will assert that fiscal and monetary policies were not used to maximum effect during World War II, and will criticize the precise form which direct controls took, I think virtually every economist will agree that fiscal and monetary controls could not effectively have replaced all direct controls.

If then we agree that direct controls were indispensable in war, we will do well to examine our reasons for advocating them, in order to inquire whether some or all of those reasons may not apply as well to their use during some peacetime situations.

The basic advantage of the use of direct controls in World War II, as Professor Galbraith has pointed out in a brilliant essay,[9] is that it permitted income incentives to be used to draw out a great increase in productive effort, without permitting the money income to cause inflation. Workers and other producers could earn enough to pile up money savings at an unprecedented rate. They believed the direct controls to be temporary, and expected their money savings to have later spendability without material loss of value. In these circumstances, anticipated future consumption, or the satisfaction of accumulation, or both, provided incentives which could not have existed in the presence of fiscal-monetary controls severe enough to close the inflationary gap.

I would like to pursue this analysis further. The necessary diversion of resources to war uses could have been accomplished without direct controls, by sharply raising the price offered for essential materials and labor in war uses. The general price level, measured in whatever way seemed appropriate, could at the same time have been kept constant (within limits set by administrative error), by causing a fall in the prices of non-war goods and

[8] Everett E. Hagen, "The Problem of Timing Fiscal Policy," *American Economic Review, Proceedings*, (May, 1948).

[9] "The Disequilibrium System," *American Economic Review*, (June, 1947).

services. This could have been accomplished by taxation which drained away such an amount of income as to reduce sharply the demand for non-war goods and services. If the same aggregate output had been achieved in the economic system by this method as with direct controls, this harsh fiscal policy would, of course, not have reduced consumption below the level to which it would have been held in any case by the scarcity of non-war goods and services.

Why did such a policy seem impractical? Not merely, I submit, because of a money illusion, nor merely because it would have removed the incentives associated with the possibility of a high money income and a high rate of savings accumulation. In addition, it would have produced a far more drastic distortion of the relative patterns of living of different consumers than did direct controls. A severe reduction in money incomes after taxes, in non-war occupations, would have been required. This would have made contractual obligations fixed in money terms, such as rent, or interest payments, or debt amortization payments of any kind, very burdensome. Consumers with such obligations would have been forced to reduce their level of living by a much larger percentage than other consumers. On the other hand, the position of persons with accumulated holdings of cash or of assets with a fixed cash value would have been greatly enhanced. These exacerbations of the burden of debts fixed in money, and of the value of money assets, would have caused the necessary reduction in aggregate national consumption to be distributed in a way far less equitable than was in fact done by direct controls. These results would have seriously injured the nation's morale, and it is clear that for this reason as well as for that advanced by Galbraith not as great aggregate output could have been achieved as with direct controls.

This simple analysis, I think, suggests a general principle: when sharp temporary distortions must occur of the long-run equilibrum pattern of resource allocation, direct controls are desirable to prevent resulting distortions in the price and income structure which will compound the problem of adjustment at the time and the problem of readjustment when the temporary period is over. It is safe to add, I think, that even though the new pattern of resource allocation is expected to be permanent rather than temporary, direct controls are preferable during the transition period if the necessary change in patterns of resource allocation is very

rapid.[10] This, I think, is the meaning of the statement sometimes made that direct controls should be used when the inflationary pressures are "too severe."

This conclusion that under certain definable circumstances direct controls are economically and socially preferable to fiscal-monetary controls for purposes of economic stabilization has, I submit, no tag on it stating, "Applicable in wartime only." If circumstances of the same description should exist in peacetime, direct controls would be preferable to fiscal-monetary ones then as well as in war. I cheerfully confess, however, that I do not believe this conclusion is of great practical signficance, except conceivably in a period of armed peace which is virtually warlike in nature. Even during such a period, unless the end of the period of inflationary pressure is definitely foreseeable, the steady accumulation of inflationary pressure under direct controls becomes important, and it would seem desirable, concurrently with direct controls, to use fiscal-monetary controls designed to steadily reduce the pressure and bring it to an end.

IV

There is another peacetime situation in which the use of direct controls is sometimes regarded as desirable. This is the case of a so-called "cost inflation" before full employment is reached. Various degrees and types of monopoly and, if you choose to classify them in a separate category, various degrees and types of imperfection in competition exist in the American economy in industry labor, and agriculture. Because of these, and also because of capacity bottlenecks, as aggregate demand increases a significant rate of price rise per time period may set in before full employment is reached. Capacity bottlenecks provide only a temporary difficulty, but the structural imperfections in competition may mean that in the absence of appropriate controls full employment cannot exist without continuing inflation.

This is a hypothesis only. Whether one believes that it holds true of the American economy at the present time depends in part upon one's judgment concerning the level of unemployment at which, under various alternative circumstances, various rates of

[10] For the price distortions will during such a transition go far beyond the changes associated permanently with the new pattern of resource allocation. Of course price incentives are desirable to speed the shift to the new pattern. A major problem of administering direct controls is to avoid choking off the price distortion so severely as to retard unduly the speed of the shift.

price rise will occur, and in part upon one's judgment concerning the level of unemployment which constitutes full employment. If one believes that the situation referred to exists, one's judgment concerning desirable policy depends upon evaluation of the relative undesirability of a given amount of unemployment, a given rate of price rise, and the use of controls necessary to prevent price rise (or to prevent a given increase in the rate of price rise) while permitting a given reduction in unemployment. Or, more precisely, one's judgment will depend upon one's evaluation of the relative undesirability of each of various possible amounts relative to the undesirability of the rate of inflation or of the degree of control of unemployment, which is the alternative of each amount of unemployment.

Assuming for the moment, before estimating the facts, that an undesirable rate of price rise will typically occur in the American economy before "full employment" is reached, unless undesirable controls are imposed, how can the dilemma be resolved? By destroying the monopolies, of course;[11] but if one believes, as I do, that labor unions, farm price supports, and many industrial monopolies will not in fact be broken up, or for various social reasons should not be, then one must investigate other remedies.

Some economists[12] argue for a very simple principle: that fiscal-monetary controls should be used to stabilize the price level as demand increases. If any group siphons off increasing demand by pushing up its individual price before full employment is reached, stability of the price level would require exertion of a contractionary (or, if you choose, counterinflationary) fiscal or monetary pressure to depress other prices, thus also suppressing the rise in employment and preventing full employment. With varying degrees of explicitness, the reasoning advanced in support of this policy is either that if the price level is held stable, the antiemployment effect of pushing up individual prices can be exposed, and by pressure of public opinion or otherwise groups can be deterred from such action without the use of direct controls; or that unemployment is preferable both to inflation and to direct controls if the choice must be made.

The analysis underlying the first reason seems demonstrably false. The first fact to be noted in this connection is that no increase in income obtained by a monopolistic group need cause either un-

[11] And also preventing the capacity bottleneck effect. See below, IV.

[12] E.g., W. J. Fellner, the late Henry C. Simons, L. W. Mints, and in modified form Milton Friedman and G. L. Bach.

employment or a rise in the price level. For any given price increase is entirely compatible with both a stable price level and full employment, provided that other groups do not insist on refusing to accept the required small decrease in income; or in some circumstances provided only that other groups do not insist on matching the increase. An increase in farm prices need not cause either inflation or unemployment if other groups are willing to grant farmers the redress of inequity which, at least in the minds of farmers, is involved. An increase in wages will cause neither inflation nor unemployment provided employers are willing to accept a "reasonable" reduction in their "swollen profits," and provided other workers whose productivity has increased less do not insist on a corresponding increase; if unemployment appears, the union may sincerely blame the employer and the employer the union. *Mutatis mutandis,* the same is true of price increases designed to widen profit margins.

Secondly, it should be noted that if a group increases its money income by monopolistic selling tactics, under a stable price-level policy, some members of the group may be injured by the repercussions of enforcement of that policy, but the group as a whole will benefit exactly as is the case in the absence of such a policy, though the degree of gain may be more or less than in the absence of such a policy. In part, that is, the gain will be at the expense of other groups.

It follows that such monopolistic action can be prevented only by such a strong attitude of censure on the part of the rest of the public that the group in question is morally coerced despite its own feeling of the rightness of its action; or by an agreement between the three major competing groups on a distribution of the national income which seems to all three to be fair. I suggest that neither development will occur.

During World War II we had such a stabilization compromise; but the three groups involved were all dissatisfied, all strained at the price controls which enforced the compromise, and all refrained from straining even harder, only because of the pressure to accept an unsatisfactory deal for the sake of not interfering with the war effort. Being able to arrive at a compromise acceptable in peacetime, and workable in the absence of legal constraints, is highly improbable.

This is true not merely because of the rejection of logic by pressure groups when their own interests are involved, but also,

I submit, because economists themselves could not agree upon the appropriate distribution of income. A starting-point for many economists might be the proposition that the price and income relationships which should be used as a standard are those which would exist under perfect competition. This is certainly an unexceptionable principle in static analysis, but Professor Schumpeter has argued so plausibly that some degree of monopoly stimulates technological advance, that I for one would not accept perfect competition as the optimum. Further, though labor union monopoly is undesirable from a narrow economic viewpoint, I submit that labor unions satisfy such basic psychological needs of rootless industrial workers, that destruction of the unions would be socially catastrophic. In this respect also, perfect competition is not optimum.

And even if economists could agree upon the optimum degree of competition, the problem would be only half-solved. For this standard would not be operational; we have no clear way of estimating the price relationships which would exist under our ideal productive structure. The world is so far from this ideal — not only because of monopoly in the crude sense, but also because of enormous imperfections in the geographical and occupational mobility of resources — that our estimates of the price-income relationships which would satisfy our criterion would be subject to gross margins of error. Even the direction, as well as the magnitude, of movement to approach the optimum would be in doubt. For example, if there were perfect geographical and occupational mobility between farm and city, would farm prices be higher or lower than they are under price supports? And by how much? And if economists could not agree, what hope is there that groups with divergent selfish interests could reach the necessary degree of agreement?

I therefore suggest that if an incompatibility of full employment and price-level stability exists at present, the problem can be met only by direct controls, or by the abandonment of either full employment or price stability. If direct controls should be the choice, these controls would determine price relationships, the distribution of income, and the allocation of resources. In view of the discussion immediately preceding, it is repetitious to note that economists do not now possess the tools and techniques to judge what decisions concerning prices, income distribution, and resource allocation would be optimum on welfare grounds.

This fact is, however, not very important in discussion of "practical" policies. I venture to assert that if farm and labor groups are politically so strong (or socially so justified in their demands) that their bids for higher incomes cannot be resisted without direct controls, then the imposition of direct controls on them, or the removal of the governmental supports which make the price rise possible, is probably also politically impossible. If we are to use direct controls in peacetime to check cost inflation short of full employment, they will of political necessity impinge primarily on profit margins through controls on product prices. Even the wartime stabilization bargain between agriculture, labor, and industry involved a much greater curtailment of industrial profits, relative to their uncontrolled full employment peacetime level, than of wages or farm prices. The crucial considerations for practical policy may thus be said to be the choice between unemployment, inflation, and direct controls so determined.

Broad social considerations are relevant to this choice. Unemployment leads to psychological stresses and frustrations which only a psychiatrist is apt to value at their true importance. I suspect that even unemployment of six or seven millions creates individual tensions strong enough and pervasive enough so that they nibble away at the stability of our social order. Inflation even at the slow rate of a 3 per cent rise in the price level per year implies doubling of the price level in less than a generation. The social and economic evils and inequities are obvious. And direct controls not only are economically costly and dull incentives, but in addition the use of direct controls for this purpose sets a precedent which may be harmful to the wisest policy choice in other matters.

Choice between these alternative evils must depend upon the magnitude of each, which is the alternative to given amounts of the others. In conclusion, I suggest that price-level stability can probably be obtained without direct controls at the cost of a much smaller level of unemployment than is supposed by many economists — a much smaller level of unemployment, in fact, than may be suggested by the preceding discussion. For there exists in the economy a cushion which can absorb a certain amount of inflationary pressure by yielding to it and granting increased income, *without permitting inflation.* An annual increase in productivity of certainly more than 2 per cent — probably closer to 3 per cent

— is in prospect.[13] This will permit an equal annual rise in the average of all money incomes (not merely labor incomes) or an equivalent reduction in the work week with no reduction in money income, without a rise in the price level.[14] A greater rise in specific prices here and there can be offset by price decreases elsewhere.

In judging whether the pressure of monopolistic groups for higher income, plus the associated rise in income of other individuals which must occur,[15] can be satisfied by this percentage rise in the nation's output it should be remembered that not all upward price pressures below full employment in the past have been caused by these monopolistic pressures. Such price movements have arisen, as I have noted, from two sources. The first is bottlenecks. But these are most apt to be serious if the rise in employment occurs after deep and prolonged depression. During such a period productive capacity in many industries will come to be far short of potential demand, both because potential demand in the economic system as a whole will probably have grown relative to capacity, and because demand will have shifted so that potential demand in some industries will have increased more than that in the system as a whole. If we can keep the economy from falling far below the capacity level, especially for a prolonged period, we will have minimized an influence which was certainly responsible in part for the price increases of 1938-41.

It is far from certain that monopoly pressures alone will push money incomes up at a rate which cannot be accommodated within the 2½-3 per cent annual margin. When farm prices sagged and in general demand softened in 1948, the price level fell slightly; and as this is written at the end of 1949 it has not risen again even in the face of almost full employment.

Whatever the final outcome of the struggle in the coal mining industry may be, developments during the last six months of 1949 indicate that even a labor union with the greatest degree of homogeneity among the members, and the strongest emotional attach-

[13] This rate of rise seems probable especially if we include in our definition of increase in productivity an increase in the value of output resulting from a shift of demand from industries of lower to industries of higher value of output per man hour. This inclusion is proper in the context.

[14] The allocation of part of this increase in productive capacity to increased governmental services weakens but does not negate this point. Labor unions bargain in some degree for wages *before taxes*, and some of the increased government services go to satisfy the demand for increasing real income.

[15] Otherwise the disparity in income would steadily grow to an intolerable point.

ment to a leader, is not all-powerful. The market situation is such that in general corporations even in this situation of almost full employment have not attempted to increase their prices in order to widen profit margins. Price increases have been limited to passing on cost increases. I do not know why the same should not be true in later similar situations. And it is significant that the recent discussion of farm policy has dealt, not with raising farm prices, but with the question of how much farther farm prices should be permitted to fall. These considerations suggest that the resistance of each producer to higher costs and of consumers to higher prices, and the knowledge by labor unions that inflation follows a general wage increase beyond a certain limit, may be sufficient on the average, though not in all individual cases, to contain the group pressures for increasing incomes within the rate of increase in productivity. Price rises here and there can be offset by price decreases elsewhere in the system, made possible by increasing productivity.

This conclusion is, of course, open to question. During recent months, potential cost-inflating forces have been counteracted by a continued moderate softening in farm prices. It would not be safe to say dogmatically that without this cushion, other upward pressures at the present level of unemployment could be met without inflation. But developments have been such as to make it rash, I think, to flatly assert the contrary. The situation offers hope.

Prices will certainly fall and rise with descent into depression and recovery from it. Also, price pressures will certainly increase as the employment situation becomes much tighter than at present. But if we can prevent serious depression, and if we will be content with the not entirely satisfactory unemployment level of three million,[16] then I think the chances are good that we can preserve stable prices and can avoid both inflation and direct controls. In this direction our hopes and energies ought to move.

[16] Because of inability to control minor fluctuations, I think we must be content with even more. See Hagen, *loc. cit.*

CAPITALISM AND ECONOMIC STABILITY: DIRECT VERSUS MONETARY AND FISCAL CONTROLS DISCUSSION

WILLIAM W. TONGUE*: One of the striking things about these papers on direct vs. monetary and fiscal controls is the apparent unanimity of opinion among professional economists that direct controls are undesirable and should be used only as a last resort. Mr. Hagen has done an admirable job of summarizing the case against direct controls from the theoretical point of view. Mr. Turner has stressed the practical problems to be faced, especially the necessity for a large measure of public support, and has compiled an exhaustive and scholarly review of the various controls actually used in the postwar period.

From this I think we can agree that direct controls should be used only under very special circumstances, such as in wartime when a rapid shift of resources is required; in specific situations where political factors are dominant, as in the case of export controls; and possibly in some areas of the economy where the price system does not work as flexibly as it might, e.g., steel allocations for defense and Mr. Turner's freight car example.

Thus, I find myself in fairly general agreement with both Mr. Hagen and Mr. Turner. Any differences I might have are rather trivial, with one possible exception. The exception relates to Mr. Turner's appraisal of the postwar controls which are now dead, but for which Mr. Turner seems to have a fond recollection. I detect a willingness on his part to allow vague notions of equity to color his conclusions without examining the alternative of what might have been accomplished in a freer market.

But these are rather small differences in comparison with the wide area of agreement that indirect controls should be relied upon in peacetime to keep the economy on a reasonably even keel. This raises the question of how far indirect controls — fiscal-monetary controls, as Mr. Hagen has put it — can go in performing this function.

Mr. McCracken has mentioned some of the difficulties confronting fiscal policy. No one disagrees that the weapon is powerful enough to be effective if it actually can be used. Most of the problems in using it revolve around the question of timing, especially the problem of getting Congress and the public to act in time and in the right *direction.*

But we are dealing with *monetary* as well as fiscal policy. And the monetary weapon has not received the attention it deserves, in

* Jewel Tea Company, Inc.

my opinion. For that reason I was especially pleased to see Mr. McCracken devote most of the space in his paper to the monetary rather than the fiscal policy tool — and I am especially pleased too, because I agree with most of what he says.

Mr. McCracken mentioned the widespread notion that monetary policy, especially interest rate policy, has little influence on the volume of expenditures in the economy, with the possible exception that tight money may be effective in controlling booms. I do not believe this notion is justified by the facts, which show that recessions and depressions have almost always been preceded by tight money and revivals have been preceded by monetary expansion. Moreover, this has been true since the advent of the Federal Reserve System as well as before, although it is also true that the fluctuations in economic activity have been much wider and have lasted much longer, in both directions, since 1913 than was the case before. This is probably not unrelated to the fact that the System succeeded in introducing a large measure of elasticity into our monetary system.

Moreover, I do not believe our experience in the 1930's justifies the conclusion that monetary policy is necessarily ineffective. A vigorous policy of monetary expansion was not started in the 1930's until *shortly before* what later turned out to be the bottom of the Great Depression. It is true that for a month or two after the stock market crash in 1929 the Federal Reserve System purchased United States government securities in the open market. But then the purchases stopped — and in 1931, as Mr. McCracken mentioned, the System actually tightened up on credit very severely, though for reasons which were thought to be beyond its control. It was not until the spring of 1932 that the System went out and purchased securities on a large scale in the open market. In March, April, May and June of 1932 it purchased over $1 billion of Governments — a very large amount for those days. It will be recalled that many economic series turned upward very shortly thereafter.

This brief review of the facts suggests that monetary policy can be a useful tool, *if it can be used under present conditions.* This brings us right up against the problem of holding down interest rates on the federal debt, and the alleged necessity of supporting the market for United States government securities at par or better, while at the same time effectively discouraging any inflationary tendencies that may appear in the economy. I believe the

magnitude of this problem is greatly exaggerated, as can be made clear by examination of a few facts which I would like to add to Mr. McCracken's excellent discussion.

First, let us consider the interest burden. A 1 per cent rise in the interest cost on the *entire* federal debt would require about $2½ billion. But if we started to raise interest rates today it would not affect the entire debt — it would affect only the part coming due currently, and of this probably only the marketable debt and Savings Notes, unless we are talking about rate increases of more than 1 per cent. When we look at the maturity schedule of the marketable debt, we see that less than $90 billion is due in the next five years, and if we add in the Savings Notes the total is still less than $100 billion. One per cent on this amounts to less than $1 billion.

Now we should ask, do we really need a 1 per cent rise in the average interest rate to curb an inflationary situation? Mr. McCracken states that permitting long-term United States government bonds to decline moderately below par would make lenders think twice before switching them to private securities or loans, and hence would be effective in slowing down the flow of credit into the private expenditure stream. I share this view. Let us suppose that we drop the long 2½'s to a price of 95 or 96. This would represent a very substantial decline from present levels around 104. But, and this is often overlooked, it would only raise the interest yield to about 2¾ per cent, or only ¼ per cent more than the coupon on the bonds! How much short-term rates would have to rise with a ¼ per cent rise in long-term rates I am not sure, but I don't see why it needs to be more than a small fraction of 1 per cent. Thus, the additional interest cost would be quite moderate with a variable interest rate policy if it is kept within price limits of say 95 and 105 on the long 2½'s.

Of course, the effectiveness of a variable bond price policy depends to a considerable extent on the establishment of stable expectations in the minds of the public as to the limits within which the variation in prices will take place. For example, in a recession the aim of monetary policy is to discourage the purchase of government securities by private investors, and to induce them to sell the government securities they hold, so that they will buy private securities or loans and thus encourage the flow of credit into the private expenditure stream. A rise in the price of long governments to 105, for example, will not accomplish this objective if the

public interprets it as a signal that prices are going to 110. In fact it will do just the opposite! The public must be convinced that 105 is the ceiling and that the only direction in which the price can move from that time on is downward.

Conversely, in a period of inflation, the aim of monetary policy should be to encourage private investors to hold the government securities they own, and to purchase additional amounts, thereby slowing down the flow of funds into private securities and the private expenditure stream. Placing the long bonds at 85, for example, will tend to restrain switching into private securities because, as Mr. McCracken has mentioned, the sale of the Governments will establish actual losses to sellers. But the favorable effects of this may be strengthened considerably if private investors can be made to believe that 95 is an absolute floor, below which the price will not be allowed to go. Investors will then have the prospect of recovering in full any paper losses they may have, and will have a positive inducement to buy additional amounts of Governments because of the prospect of substantial capital gain when economic conditions call for a reversal of bond price policy.

It can readily be seen that with the establishment of stable expectations regarding, first, the prospect that bond prices will fluctuate, and second, the approximate range of fluctuation, the Federal Reserve System's bond price policy can be made into a very effective and flexible indirect instrument of control. In fact, it could conceivably become too powerful if these expectations became very strong and widespread. This suggests that while it might be wise to establish the expectation that prices of long-term bonds will certainly fluctuate, it might not be wise to set out the exact limits within which this fluctuation will take place. This suggests, in turn, that it may be possible to reconcile the Federal Reserve System's desire for flexibility of bond prices with the Treasury's desire to maintain a floor of par under long-term bonds.

The expectation that long-term government bond prices will never be allowed to go below par, has already been established fairly effectively. If the Federal Reserve would now come out and publicly declare that it will not permit the market to go below par it would seem that this expectation could be established almost beyond question. Then, if the Federal Reserve System would announce at the same time that in periods of recession it would encourage bond prices to rise, as it did in 1949, it would seem that the expectation could be quickly established that bond prices will

certainly fluctuate inversely with business conditions, though the exact range of fluctuation might be left uncertain. With the establishment of such expectations, open market policy can conceivably be made into just as effective an instrument of control as it could by abandonment of support at par, and far more effective than it has ever been in the past. Perhaps the Treasury, by firmly insisting on support at par, has actually done the Federal Reserve System a great favor!

Thus, I think the conclusion is an optimistic one. Monetary policy can be forged into an effective instrument by action along the lines I have sketched above. It is also very flexible and can be revised quickly to meet changing conditions. If by chance it is not sufficient to keep the economic situation from getting out of hand at some time, we can then bring up the more cumbersome, but more powerful, heavy guns of fiscal policy.

RICHARD C. YOUNGDAHL*: In a discussion set up under a title as controversial in tone as this one, it is striking to find as broad an area of agreement as our speakers have presented. Except in special circumstances such as in wartime, direct controls have not in general been proposed as major instruments for economic stabilization. There seems to be a consensus that the government contribution to maintenance of general economic stability in peacetime should be primarily through the fiscal-monetary instruments.

Both Professor Turner and Professor Hagen have advanced analysis that tends to play down the peacetime roles of direct controls as general measures for maintenance of economic stability. Professor Turner has traced the history in the postwar period of direct controls, which indeed have been much more numerous than we may generally realize. In his statement of the conditions under which direct controls can be effective, however, he has carefully, and I believe properly, circumscribed their use.

Professor Hagen has made a strong case against using direct controls on a continuing basis for supplementing fiscal-monetary controls. He has argued, however, that under conditions when very sharp changes must occur in resource allocation, direct controls can be valuable instruments for economic stabilization in that they permit the use of income incentives, and that they reduce distortion in living patterns of individual consumers from what would

* Board of Governors of the Federal Reserve System.

be involved were the government to adopt a fiscal policy adequate in itself for stabilization. But as a practical matter he has concluded that, in peacetime, situations are not likely to arise where general use of direct controls would be appropriate. The discussant is in agreement with these conclusions.

In his excellent review and analysis of the present status of monetary and fiscal policy, Professor McCracken has emphasized that there are some very real problems in the use of monetary instruments for stabilization, particularly with the government debt at the size it is. For monetary and credit policy to be effective, and indeed if it is not partially to offset a proper fiscal policy, interest rates must be flexible. It has for some years been fashionable among many economists to minimize the role of the interest rate. It is frequently alleged that small changes in interest rates have no appreciable effect on economic decisions. Large rate changes are ruled out as undesirable, so the conclusion is reached that perhaps no changes are appropriate. The legislator and the taxpayer, as Professor McCracken has suggested, are easily convinced that there should be no increase in expenditure for interest on the public debt.

McCracken put it aptly, however, when he said that such a view regarding the role of interest rates results from "analyzing the symbol as the substance." Changing interest rates involves far more than just charging a borrower a little more, or a little less, for a loan. Without pretending to be complete, I should like to comment briefly on three aspects from which the influence of changes in interest rates on the volume of expenditures may be considered. I should preface this by noting that monetary policy works well only when it can be applied in time to prevent a major crisis from arising. It is primarily an instrument for maintaining balance in the economy, and its effectiveness (and the effectiveness of changes in interest rates which symbolize and reflect monetary policy) should be judged in such a context and not in terms of a 1932 or of a 1947.

1. Stability in the economy requires that there be a group of marginal investors who are deciding to step in with new projects as other projects are completed and productive resources released. Not many of these projects may be so narrowly profitable that a small change in the cost of credit will cast the balance for or against it. But though a project may be adequately profitable even at a higher interest cost, there may still be a desire on the

part of borrowers to scalp the money market and maximize the return. The effect of relatively small interest rate fluctuations may thus be important on the timing of capital ventures, and an influence over the timing of a portion of capital expenditures may be exactly what is needed from monetary controls in many periods. Such an influence is not possible, if the level and structure of interest rates are fixed or can change only very slowly.

2. Fluctuations in interest rates have a great deal to do with the ability and willingness of lenders to lend. Unless the Federal Reserve were to have much more power over the assets of banks than it now possesses, it would not be possible in an expansionary period to put growth in the total volume of bank credit to private borrowers under appropriate restraint without such action being reflected in a change in the yields on government securities. On the other hand, within a comparatively modest range of changes in these yields it may be possible to do a great deal to affect the availability of bank credit to private borrowers.

With respect to other institutional lenders, the case for flexibility in market interest rates is likewise a good one. Some of these financial institutions, like banks, operate on semi-rational concepts of liquidity needs and react sharply to developments that affect their liquidity positions. Certain financial institutions, moreover, such as investment bankers, work on very small margins and are strongly influenced in the volume of their activities by changes in yields and prices of securities.

3. Interest rates are the capitalization factors of the economy. A decline in interest yields means a rise in the value of claims on income, other factors equal. The Federal Reserve, by permitting or bringing about a decline in market interest rates, may increase the money value of a large segment of the assets of the economy. Holders of these assets will feel richer. Conversely, a rise in interest rates will reduce the value of certain asset holdings and their owners will feel poorer. With the huge marketable government debt we now have, the influence of comparatively small interest rate fluctuations may be very significant on liquidity positions of important sectors of the economy and their decisions to spend or not to spend, or lend or not to lend.

As Professor McCracken indicated, monetary policy cannot function effectively as an instrument for economic stabilization unless interest rates are free, to move, at least moderately. In fact, if they are not, the influence of monetary policy may be to accentuate rather than dampen fluctuations in economic activity.

THE MOVEMENT OF DEBT TO INSTITUTIONS AND ITS IMPLICATIONS FOR THE INTEREST RATE

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A review of the mortgage and bond markets since 1920 shows an impressive trend from direct individual to indirect institutional investment in the country's long-term debt. The figures suggest interesting possibilities both for those engaged in investment and the economist. The chief of these are (1) that now investment money appears to be coming more largely from middle income than wealthy investors, (2) that thrift institutions may be developing a savings stream beyond the ability of the community to supply suitable debt investments, and (3) that interest rates may continue at very low levels even without the artificial assistance of the Federal Reserve Banks. The reason that these possibilities cannot be labeled as conclusions will appear in the figures which show how the huge relative increase in federal government expenditures mean that its deficits and surpluses result in debt market operations of dominating importance.

The government has also created two new institutional factors which within less than a decade have risen to a position that rivals, even if it does not as yet eclipse, our most important private institution, the life insurance company. The well-known Series E savings bond, restricted to the individual investor and the amount to each limited, has within less than ten years grown to a $35 billion total and in spite of huge postwar redemptions has climbed slightly in 1947 and 1948. Federal agencies and trust funds have also become an investment market factor of the first rank. They consist of such funds as those for Old Age Retirement, Unemployment, civil service retirement, and national service life insurance and have grown to some $39 billions. Confined to investment in federal obligations, they own a very respectable 15 per cent of our quarter-trillion national debt and correspondingly reduce the amount available for private investors. The influence of these government institutions in the investment market will be considered in the following discussion.

LONG-TERM CORPORATE DEBT

The total amount of corporate long-term debt is shown in Table 1 at intervals over the period 1920–48, as are the holdings of the

chief institutional investors in that field—the life insurance companies, the mutual savings banks, and the commercial banks. The percentages show the steady rise in the proportion held by these institutions through both ups and downs in the total until in the final year, 1948, when their share was one-half of the total. These figures understate the share of the commercial banks in the later years, since they include only bond holdings and omit that part of their term loans with maturities over one year, which are a part of the long-term debt total.[1]

TABLE 1

LONG-TERM CORPORATE DEBT

A. Dollar Amounts (billions)

Year	Total†	Life Insurance Co's‡	Mutual Savings Banks§	Commercial Banks‖	Total Institutional Holdings
1920	32.6	2.2	1.8*	5.2*	9.2
1925	39.7	3.0	2.2*	7.3*	12.5
1930	51.1	4.9	3.2*	8.1*	16.2
1935	43.6	5.2	2.9*	4.2	12.3
1940	43.7	8.6	2.1	3.5	14.2
1945	38.3	10.3	1.2	3.3	14.8
1948	49.6	18.7	2.2	3.4	24.3
		B. Percentages			
1920	100	6.7	5.5	16.0	28.2
1925	100	7.6	5.5	18.4	31.5
1930	100	9.6	6.3	15.9	31.7
1935	100	11.9	6.7	9.6	28.2
1940	100	19.7	4.8	8.0	32.5
1945	100	26.9	3.1	8.6	38.6
1948	100	37.7	4.4	6.9	49.0

*As of June 30.

†E. T. Bonnell, "Public and Private Debt in 1948," *Survey of Current Business*, (October, 1949), p. 8.

‡Estimates of all companies based on data of 49 companies constituting 90-95 per cent of the total assets of the industry. Data for 49 companies from *Proceedings of Forty-First Annual Meeting of Life Insurance Association of America* (December, 1948), p. 36. 1948 estimate by author based on data from 1949 *Life Insurance Fact Book* (New York: Institute of Life Insurance: 1949), p.48.

§1920-1935. *Banking and Monetary Statistics*, p. 25; 1940-1948, *Federal Reserve Bulletin* (April, 1949), p. 398.

‖Data are for category "Other Securities" which include all investments except U. S. government and obligations of states and political subdivisions. 1920-30, data for all commercial banks:—*Annual Reports of the Comptroller of the Currency;* 1935-40, data for all insured commercial banks: *Banking and Monetary Statistics*, p. 109; 1945-48, *Federal Reserve Bulletin* (September, 1949), p. 1102.

The table shows that the rise of life company holdings has been the most important factor in the expansion of the institutional share in this market made up chiefly of bonds but also including corporate mortgage loans and term loans. (Sometimes "term loan" is defined broadly enough to include the amortized mortgage

[3] On November 20, 1946, $4.5 billion of the $13.2 billion business loans of member banks had an initial maturity of over one year (A. R. Koch, "Business Loans of Member Banks," *Federal Reserve Bulletin*, [March, 1947] p. 253).

loan made to a business.) These companies held less than 7 per cent of the total in 1920, nearly 38 per cent in 1948. Although this trend was apparent during the 1920's when financing was active, the displacement of the individual investor has been most apparent since then. With the refunding of coporate obligations at rates of 3 per cent or less, the life company, under pressure to keep fully invested, has been a leading buyer, often acquiring the total issue of a corporation by private placement. At such rates of interest, the individual finds little attraction, especially when the government offers such an instrument as its savings bonds paying 2½ to 2.9 per cent for a 10- to 12-year investment wholly free from the risk of market fluctuation.

Interestingly enough, institutional purchases outran the creation of additions to corporate debt during the postwar years 1946-48 when borrowing was active as a result of both inflation and the stimulation from demands pent-up by the war years. The rise in the price level during 1946 and 1947 added considerably to the need for increasing the dollars invested in business assets. This expansion of borrowing from inflation was reflected in an immediate rise in the current assets, a slower and more prolonged rise in fixed assets. An idea of the magnitude of this influence may be had by considering the approximate current asset needs from this one factor in the year 1947 for all manufacturing corporations. During that year wholesale prices of other than farm products rose 16 per cent, which if applied to the three chief current assets of cash, receivables, and inventories of March (the earliest figures published by the SEC) totalling $46.5 billions would indicate a need for funds amounting to $7.4 billions, or a figure equal to 11.9 per cent of the $62.8 billions of net worth.[2] Such a calculation ignores the effect of inflation upon fixed asset needs or any physical expansion of facilities. From the standpoint of the stability of the economy and the solvency of business, it is fortunate that so much of the "financing" of this period was from internal sources, especially retained earnings, rather than borrowing. Much of the reported earnings were, of course, nominal rather than real, reflecting the price inflation of the assets on the other side of the balance sheet when the latter were replaced at the higher price level.

[2] Federal Trade Commission and Securities and Exchange Commission, Quarterly Industrial Financial Report Series. The need for increased investment in inventory resulting from price inflation has been widely recognized but the similar need for added investment in receivables and operating cash balances has often been ignored.

In 1947, manufacturing concerns used funds from retained earnings and depreciation allowances four times the amount of new security issues and bank loans. Utilities, whose needs are almost wholly for fixed assets, derived only two-thirds as much from these two internal sources as compared with external sources. The relative importance of the chief internal and external sources for all corporate business are shown in Table 2 for the years 1946-48. The failure of the sources and uses to balance is the result of omitting lesser items (given in the source), such as the disposal of government obligations acquired during the war and changes in the current liabilities other than bank loans, which reflect tax liability and interbusiness credits.

TABLE 2

MAJOR SOURCES AND USES OF CORPORATION BUSINESS FUNDS
1946-1948

(billions of dollars)

	1946	1947	1948
A. Chief Sources			
Internal:			
Retained profits	6.3	10.6	11.3
Depreciation	4.1	4.5	5.0
External:			
Bonds and notes	1.0	3.1	4.5
Bank loans	3.3	2.9	0.8
B. Chief Uses			
Inventories	7.5	3.1	4.5
Receivables, etc.	4.7	5.8	4.5
Plant and equipment	11.6	15.0	16.9

Source: *Survey of Current Business*, March, 1948, February, 1949.

REAL ESTATE MORTGAGE LOANS

Mortgages have characteristics which make them more suitable for institutional than individual investment. They come in larger units than bonds or stocks and so make diversification more difficult. They require more care and management than corporate securities and, until the advent of the FHA-insured loan, lacked marketability. Table 3 shows that, as in the case of corporate obligations, institutional holders were increasing their share of the total over the period studied.

TABLE 3

NON-CORPORATE MORTGAGE DEBT URBAN AND FARM

A. Dollar Amounts (billions)

Year	Total†	Life Insurance Co's‡	Mutual Savings Banks§	Insured Commercial Banks‖	Savings and Loan Assn's#	Total Institutional Holdings
1920	22.1	2.2	2.6*	.....	1.7	.....
1925	31.3	4.8	4.3	.....	4.2	.....
1930	42.1	7.6	6.0	.....	6.4	.....
1935	33.5	5.3	5.2	3.3	3.3	17.1
1940	33.7	6.0	5.0	4.5	4.1	19.6
1945	32.5	6.6	4.3	4.7	5.4	21.0
1948	51.5	10.9	5.7	10.7	10.4	37.7

B. Percentages

1920	100	10.0	11.8	.....	7.7	.....
1925	100	15.3	13.7	.....	13.4	.....
1930	100	18.0	14.2	.....	15.2	.....
1935	100	15.8	15.5	9.8	9.8	50.9
1940	100	17.8	14.8	13.3	12.1	58.0
1945	100	20.2	13.2	14.4	16.6	64.4
1948	100	21.1	11.0	20.7	20.2	73.1

*As of June 30.

†See reference (†) Table 1.

‡1920: *Proceedings of the Fifteenth Annual Meeting of the Association of Life Insurance Presidents*, (1921), p. 114; 1921-47, *1949 Life Insurance Fact Book*, (New York: Institute of Life Insurance, 1949).

§Data consists of total loans outstanding. 1920-40: *Banking and Monetary Statistics*, p. 23; 1945-48: *Federal Reserve Bulletin*, (September, 1949), p. 1101.

‖1935-40: *Banking and Monetary Statistics*, p. 109; 1945-48: *Federal Reserve Bulletin* (September, 1949), p. 1102.

#1920-45, "1947 Statistical Supplement," *Federal Home Loan Bank Review*, p. 7 (Federal Home Loan Bank Administration, Washington); 1948: U. S. Savings and Loan League.

In the earlier years between 1920 and 1930, the institutions other than the commercial banks increased their share of this form of investment from 29 to 47 per cent of the total. In the years 1930-35, the holdings of this group shrank from 47 to 41 per cent, largely as the result of the taking over of some $4 billions of defaulted home and farm mortgages debt by the Home Owners' Loan Corporation and Federal Farm Mortgage Corporation. These corporations, in turn, issued their government guaranteed bonds to the former mortgage holders. The gradual liquidation of the mortgages held by these two government agencies decreased the share of mortgages held by "others" in succeeding years, 1935-48.

The four institutions increased their share of the total from about one-half to three-quarters between 1935 and 1948. Unlike the corporate debt field, here the most active factors in the overall growth were the savings and loan associations and the commercial banks followed by the life companies. Savings banks increased their holdings so slowly that they had not recovered to their 1930 holdings in 1948, although they presumably have passed that mark since.

The rise of the FHA-insured mortgage has facilitated the expansion of institutional holdings. Only approved institutions are permitted to acquire these guarantied loans. Furthermore, since 1934 FHA insurance of loans up to 80 and 90 per cent (higher for Veterans' Administration) of the value of the property has reduced the need for individuals to take back and retain for their personal investment any high percentage mortgages or second mortgage paper made when they are selling to persons able to make only a small down payment. Many individuals during the 1920's held mortgages acquired as an incident of sale, not as a matter of choice but because the necessary borrowing was too large a percentage of appraised values to meet institutional lending standards.

State and Municipal Debt

Table 4 shows the holdings of state and municipal bonds by life insurance companies and commercial and savings banks. Their share was approximately a sixth of the total available for public investment during the 1920's. Although during the 1930's the search for investments led the life companies to expand their holdings, the chief factor in the growth was the expansion of commercial bank holdings, which grew partly from their willingness to purchase short maturities on a very low yield basis and partly the advantage they derived from tax exemption of interest from these bonds, which produced substantial savings as corporate income tax rates rose. The tax-saving is relatively unimportant for both the life companies and the mutual savings banks.

TABLE 4

STATE AND MUNICIPAL DEBT

A. Dollar Amounts (billions)

Year	Total†	Life Insurance Co's‡	Mutual Savings Banks‖	Commercial Banks‖	Total Institutional Holdings
1920	5.9	.3	.2*	.5*	1.0
1925	10.0	.4	.2*	.9*	1.5
1930	14.1	.6	.5*	1.2*	2.3
1935	16.0	1.1	.9*	2.7	4.7
1940	16.5	1.8	.6	3.6	6.0
1945	13.7	.6	.1	3.9	4.6
1948	16.2	.6#	.1	5.5	6.2
		B. Percentages			
1920	100	5.1	3.4	8.5	16.9
1925	100	4.0	2.0	9.0	15.0
1930	100	4.3	3.5	8.5	16.3
1935	100	6.9	5.6	16.9	29.4
1940	100	10.9	3.6	21.8	36.4
1945	100	4.4	0.7	28.5	33.6
1948	100	3.7	0.6	34.0	38.3

*As of June 30.
†See reference (†) Table 1.
‡See reference (‡) Table 1.
‖Annual Reports of the Comptroller of the Currency.
‖See reference (‖) Table 1.
#Estimate.

Whenever the supply of municipals grows to the point where it exceeds the demand from commercial banks and wealthy individuals seeking tax exemption, yields for long maturities would be expected to rise to the point where they would attract life company and savings bank buying. Because of the lack of interest of these institutions in the exemption feature such yields would have to be competitive with the return from federal and corporation bonds. (Under the new tax formula for life companies, they may find a small value in the exemption feature.)

The total figures shown in the table are net after the deduction of any holdings by the states and municipalities, so as to reflect only the amounts available for investment by the public. Purchases for state and municipal employee retirement plans appear to have been a growing market factor save for the war and postwar period when new municipal issues were lacking or federal government obligations were available with higher yields. In 1948, the volume of state and municipal debt held for such funds and other purposes was $2.5 billions, or 15.4 per cent of the total outstanding.[3]

Federal Obligations

In studying the interest-bearing federal debt figures, three points must be kept in mind that affect either their comparability with those in previous tables or their interpretation. The first is whether any attempt should be made to separate long and short maturities in view of the general inclusion of only the former in previous tables. Most statistics do not show the holdings separated on this basis, so total figures are used, although samples of practice by various institutions can be obtained from Treasury surveys.

Investors, both institutional and individual, shift from maturity to maturity, finding the variety one of the advantages of this field. The one-year point becomes a dividing line of doubtful comparability for the superliquid governments.

The second point is the inclusion of the guarantied as well as the direct debt in the table's total. Treasury policy since the early 1930's has been to refinance the guarantied obligations of agencies and supply their needs directly from the Treasury with funds raised by direct financing. Were there not this interchangeability, a strong argument could be made for the omission of obligations of such organizations as the Home Owners' Loan Corporation and

[3] Bonnell, *op. cit.*, p. 10.

Reconstruction Finance Corporation, supported as they are by income-producing assets.

Finally, there are the government obligations owned by the various agencies and trust funds of the federal government. Since they are no longer available for private investment, they have been excluded so that the total amount shown in Table 5 is the net amount of debt publicly held. Withdrawal of such amounts, whether from social security tax receipts or otherwise, has the same market effect as repurchase from a Treasury surplus. Use of net debt has the advantage of underlining the shrinkage in the portion held by the public since 1945. The importance of the point is discussed later.

TABLE 5

PUBLICLY HELD FEDERAL DEBT

A. Dollar Amounts (billions)

Year	Total†	Life Insurance Co's‡	Mutual Savings Banks§	Commercial Banks§	Federal Reserve Banks§	Savings and Loan Assns.‖	Total Institutional Holdings	Savings Bonds Series A-E#
1920	23.7	0.8	0.8*	3.8*	0.3*	.....	5.7	.....
1925	20.3	0.6	1.1*	4.6*	0.4*	.....	6.7	.....
1930	16.5	0.3	0.5*	5.0*	0.6*	.....	6.4	.....
1935	34.4	2.9	1.5*	12.7*	2.4*	.....	19.5	.....
1940	44.8	5.9	3.2	17.8	2.2	0.1	29.2	3.2
1945	252.7	20.6	10.7	90.6	24.3	2.5	148.7	34.3
1948	216.5	16.7	11.5	62.5	23.3	1.5	115.5	34.4

B. Percentages

1920	100	3.4	3.4	16.0	1.3	.....	24.1	.....
1925	100	3.0	5.4	22.7	2.0	.....	33.0	.....
1930	100	1.8	3.0	30.3	3.6	.....	38.8	.....
1935	100	8.4	4.4	36.9	7.0	.....	56.7	.....
1940	100	13.2	7.1	39.7	4.9	0.2	65.2	7.1
1945	100	8.2	4.2	35.9	9.6	1.0	58.8	13.6
1948	100	7.7	5.3	29.0	10.8	0.7	53.6	16.0

*June 30.

†See reference (†) Table 1.

‡1920: Estimated from *Proceedings of the Fortieth Annual Meeting of the Life Insurance Association of America*, (December, 1947), p. 48; 1925-48: *Life Insurance Fact Book*, (1948), p. 48.

§1920-40: *Banking and Monetary Statistics*, p. 512; 1945-48: *Federal Reserve Bulletin* (July, 1948), p. 844; (April, 1949), pp. 398-412.

‖1940-45: *Statistical Abstract of the United States* (1948), p. 440; 1948: *Federal Reserve Bulletin*, (March, 1949), p. 246.

#*Federal Reserve Bulletin*, (February, 1941), p. 149, (January, 1946), p. 64, (January, 1949), p. 55.

Table 5 shows the institutional distribution of the publicly held federal debt. The Federal Reserve Banks have been added to the list of institutions because of their holdings in this one field. The same growth of the share held by institutions seen in the earlier tables appears here for the two decades through 1940. The percentage held increased from 24 per cent in 1920 to 65 per cent in 1940. Only during the war and postwar period does their total

shrink first to 59 per cent in 1945, then to 54 per cent in 1948. During the war the dollar holdings grew for all institutions but in the three postwar years both dollar and percentage shares decreased for the commercial banks, life companies, and savings and loan associations. Federal Reserve holdings shrank from $24.3 to $23.3 billions but increased percentagewise. Savings bank holdings actually increased from $10.7 to $11.5 billions.

The commercial bank figures are of particular interest because of their bearing on the postwar inflation.[4] Not only did the holdings of governments decline ($90.6 to $62.5 billions) in the 1945-48 interval but the accompanying increase in Loans and Discounts ($26.1 to $42.7 billions) was less than offsetting and demand deposits (excluding interbank deposits) actually decreased ($105.9 to $93.7 billions).[5] The fuel for the postwar inflation was evidently laid during the war rather than the postwar period. In the five years, 1941-45, commercial bank holdings of governments rose from $17.6 to $90.6 billions and Federal Reserve holdings from $2.2 to $24.3 billions with a parallel rise in our deposit currency.

The two chief financial institutions omitted are the fire and casualty insurance companies which together held $3.3 and $4.6 billions of governments in 1945 and 1948, respectively. Nonfinancial business corporations had holdings of $18.6 and $12.0 billions and unincorporated businesses $10.0 and $7.5 billions in these years.[6]

Any analysis of institutional holdings would be incomplete without recognition of the rise of a rival "thrift institution" in the U.S. savings bonds. The Series E bond with its fixed schedule of redemption values and cashable at any time after 60 days from purchase, although nominally a ten-year bond, is actually more like a savings deposit. As such, it competes with savings accounts

[4] Because a substantial part of the increased Federal Reserve and commercial bank holdings represent "monetization" of federal debt rather than ordinary savings, some economists would prefer elimination or "adjustment" of these figures. Three counterproblems may be noted. (1) Some commercial bank purchases, especially of long maturities, were acquired with savings deposits. (2) Some demand deposits, especially in times of low interest rates, are held as an investment, that is, they serve as a "store of value" rather than "circulating medium." (3) Some would even argue that monetized debt, appearing as increased demand deposits, is like any other asset and requires saving for its acquisition. The author prefers the unadjusted data with the reader making his own adjustments.

[5] This deposit shrinkage, as is pointed out later, was in government rather than private deposits but that is merely to say that activity and so the need for "cash" shifted from government to private business. The special factor of "excess" government deposits at the 1945 year-end is also discussed later.

[6] *Federal Reserve Bulletin*, (July, 1949), p. 794.

in commercial and savings banks and the withdrawable shares of savings and loan associations. In contrast to the older postal savings system which was originally set up to pay a return much lower than private institutions, these savings bonds, if held for more than a few years, pay considerably more than a savings deposit. When held for the full term, their 2.9 per cent yield is more than many savings and loan associations pay and more than major life insurance companies bind themselves to accrue on reserves for present-day policy contracts.

These bonds, including their similar predecessor Series D bonds, totalled only $3.2 billions in 1940, rose to $34.3 billions in 1945, and were $34.4 billions at the end of 1948. They now outrank both the savings banks and savings and loan associations in size and about equal the $35.9 billions of time deposits held by commercial banks.[7] Drives similar to those used during the war are still staged to encourage their sale. By diverting consumer incomes to investment, they have served to counteract inflationary tendencies. When the inflation hazard appears to have passed, the question as to their proper place and the Treasury's policy toward them will be of large interest to the thrift institutions. When held to maturity, they pay a higher rate than any other government obligation now being issued or that has been issued for some years. If the Series E bonds were treated as another "institution" in Table 5, the institutional share would have been increased to 72, 72, and 70 per cent in the three years, 1940, 1945, and 1948, respectively.[8]

Significance of Growth in Institutional Share

With this broad picture before us of the various fields of debt investment, the tendency for the share of the leading financial institutions to increase over the years is clearly discernible. The only exception is in the field of federal obligations since 1940. Even there, the tendency persists through 1945 if the Series E bonds are regarded as a kind of savings bank and an institutional channel.

In trying to understand this trend to indirect investment, it could be argued that the same individuals and income groups have merely switched from direct to institutional investment. More probably, however, the diversion suggests a shift in the relative

[7] *Ibid.*, p. 815.

[8] The somewhat similar Series F and G. Savings bonds pay a lower rate and are available to institutions as well as individuals and so are given no special attention here.

importance of high income as compared with middle and low income groups, such as might be expected under the present personal income tax structure. Direct investment is more characteristic for the former. For them to shift from the ownership of mortgages and bonds to institutional investment would mean a lowering of income. Such a willing sacrifice of yield seems unlikely. The diversification and management offered by the savings bank, the savings and loan association, and the commercial bank time deposit have their chief appeal for the small and middle-class investor rather than the well-to-do.

With regard to the most important institution, the life insurance company, the answer is not so clear. (1) Recipients of income in the high-income tax brackets find a special advantage in life policies which combine savings with insurance. No taxable income is derived on such a contract until it is cashed, and even then only when the cash proceeds are in excess of premiums, which means that insurance costs as well as operating overhead are an offset to any income from the investment part of the contract. (2) Annuity contracts, by permitting elderly persons of wealth to use principal for their personal spending needs, facilitate transfers of their other property before death, thereby substituting the lower gift taxes for the higher estate and inheritance taxes. (3) Deferred annuities produce no taxable income during the period of accumulation and, after retirement when the annuity begins to pay, one's income is presumably lower and taxes are less. This point explains the popularity of retirement annuities for high-income executives, who would benefit little after taxes from salary increases. Often, however, such corporation retirement plans include middle-income employees, who receive more total income than the few highly paid executives.

The whole subject of the ownership of the savings flowing into debt investment requires further evidence, but the increasing importance of these financial institutions as compared with direct investment points in the direction of a redistribution of the beneficial shares in that debt from higher to lower level income groups.

Savings and Investment Opportunity

The other major point suggested by the increasing share of our financial institutions in the nation's long-term debt investments is that they may be building thrift habits that are producing a stream of savings that will outrun the supply of sound debt investment

opportunities. In the strict economic sense, supply cannot exceed but will always equal demand at some price. The economist is not too concerned with whether the supply is from new issues or resale by former holders. But institutional investment management becomes concerned when its demands exceed the supply of net debt additions, especially on the scale shown in the tables during the 1930's and in a manner which could happen again in the future. In examining the unabsorbed balance of debt investment, they note that some is rather firmly held by trustees and individuals even at present low interest rates and some is distinctly not of investment caliber, as in the case of certain railroad issues.

During the 1920's the actual holdings of non-institutional investors in mortgages and corporate bond issues did increase, while their fraction of the total shrank. The shrinkage of federal obligations fell entirely to their lot. In the 1930's the institutional holdings actually rose while the shares of "others" was declining in every field except the federal debt. As for the latter, "others" only accounted for $5.5 billions out of the 1930-40 expansion of $28.3 billions, or considerably less than the amounts they lost in mortgage and bond holdings.

For the war and postwar periods, the situation is best summarized in Table 6. Between 1940 and 1945, the institutions gained

TABLE 6

INSTITUTIONAL HOLDINGS SUMMARIZED: 1940-45; 1945-48
(billions of dollars)

	1940	1945	1948
Corporate:			
Institutions	14.2	14.8	24.3
Others	29.5	23.5	25.3
Total	43.7	38.3	49.6
Mortgages:			
Institutions	19.6	21.0	37.7
Others	14.1	11.5	13.8
Total	33.7	32.5	51.5
State and municipal:			
Institutions	6.0	4.6	6.2
Others	10.5	9.1	10.0
Total	16.5	13.7	16.2
Federal:			
Institutions	29.2	148.7	115.5
Others	15.6	104.0	101.0
Total	44.8	252.7	216.5
All four fields:			
Institutions	69.0	189.1	183.7
Others	69.7	148.1	150.1
Total	138.7	337.2	333.8

both corporate and mortgage holdings at the expense of diminished holdings by others. Only in the hugely increased federal field was the share of other investors increased both relatively and absolutely. Because of this exception, the three postwar years are of particular interest.

Again, in the 1945-48 interval, we note the institutional group substantially increasing both its absolute and relative position save in federal obligations. They absorbed virtually all of the $11.3 billion increase in corporates and all but $2.3 of the $19.0 billions increase in mortgages. Both institutions and others reduced their federal debt investments, but the institutional group much more decisively. The institutional reduction in federal obligations of $33.2 billions was so large as to cause a net decline of $5.4 billions in total institutional investment for all four fields combined. Reference to Table 5 reveals that $28.1 of the $33.2 billions shrinkage in the institutional holdings of governments fell in the commercial bank field. The explanation of this decline is to be found partly in the Treasury's redemption of a portion of its debt from its excess balances, resulting from overfinancing its needs in 1945 and a consequent reversal of bank credit expansion. During calendar 1946 the gross public debt was cut $19 billions through reduction in the Treasury's general and cash balances. These balances were reduced $22.5 billions, chiefly by debt shrinkage; the difference was accounted for by a Treasury deficit of $2.5 billions and trust account operations of a billion.

The other major element was a shifting to other forms of lending in the private credit field. During this three-year period Loans and Discounts, excluding real estate loans, expanded by $10.2 billions. Had this short-term lending been included in the debt figures used, the over-all picture of institutional investment would have been changed from one of shrinkage to one of expansion during this period. That the commercial banks were making a contribution to the supply of investment funds during this period is indicated by an expansion in time deposits of $5.5 billions.

THE RECENT RECORD

For the reader interested in the further study of the details of the most recent investment market record, the more significant elements are summarized in Table 7.

In reading this table, certain points should be noted:

1. Because the federal debt reaches not only into the investment, but also into the money market through the commercial banks and the Federal Reserve Banks, the division made between the two is an arbitrary one. They must be studied together because pressures are being constantly transmitted back and forth

TABLE 7

SOME INVESTMENT MARKET FACTORS: 1946-48
(billions of dollars)

	1946	1947	1948
Demand factors:			
Investment market			
Long-term corporate	3.0	3.5	4.8
Real estate mortgages	5.7	6.6	6.7
State and municipal	— 0.1	0.8	1.8
Subtotal	8.8	10.9	13.3
Federal, Net direct and guarantied	—23.0	— 6.4	— 6.8
Subtotal	—14.2	4.5	6.5
Money market			
Loans and discounts	3.8	6.2	3.8
Total	—10.4	10.7	10.3
Institutional supply factors:			
Life insurance companies	3.5	3.2	3.6
Savings and loan associations	1.5	1.4	1.3
Savings banks	1.5	0.9	0.7
Commercial bank time deposits	3.7	1.5	0.5
Total	10.2	7.0	6.1
Factors connected with federal debt:			
Series E bonds	— 0.8	0.3	0.6
Federal agency holdings	3.9	3.5	2.9
Treasury surplus or *deficit*	— 2.5	2.4	5.2*

Source: *Federal Reserve Bulletin, Treasury Bulletin* and Bonnell, *op. cit.*

*Surplus before taking into account $3 billion transfer from Treasury general fund to Economic Cooperation Administration Trust Fund in June, 1948. After transfer, 1948 surplus on calendar-year basis was $3.9 billion.

by such events as the funding of bank-held loans into bonds and the sale of short-dated bond maturities by insurance companies to banks.

2. The peak growth for corporate debt has probably been passed. In the long-term field, railroads are unlikely to add much to their total debt. Industrials, while likely to require new financing, are likely to show a greatly diminished net demand upon the debt market now that the large needs caused by postwar inflation and by urgent accumulated plant deficiencies have been cared for. Utilities are likely to constitute the chief source of any further net

long-term corporate debt increase. As for Loans and Discounts, other than for real estate, the year 1949 saw a rapid decline in net demand, which was logical since, as we saw earlier, a large part of current asset expansion arose from inflationary price increases.

3. Real estate mortgages were the largest element of demand for investment funds. Even though gross demand should continue high, these will be offset by a rising volume of repayments each year. This field is one in which low interest rates make possible a higher volume of debt relative to the income of the borrower than was the case in the 1920's. The longer amortization periods have the same effect. Those economists who have belittled the importance of interest rates upon the demand for funds, have usually ignored the large part which interest plays in the cost of housing and of the services of public utilities, both major users of borrowed funds.

Probably the cost for the use of capital is around a half of the total costs of a house, and it far exceeds each of the other three major costs — depreciation, taxes, and maintenance. (One of the ironies of the level monthly payments for interest plus amortization on housing loans running for such a long period as the FHA's twenty to thirty-two years is that it results in an increasing cash outlay for the home-owner over the years. As the house gets older and its rental value lower, the important item of upkeep for repairs and renewals increases, while his loan remains a constant burden.)

4. Among the list of institutions under the supply heading, the life insurance companies are clearly making the largest contributions to the pool of investment market funds. Because of the long term over which their contracts run, this growth is likely to be the most persistent. A bank or a savings and loan association may reduce its promotional efforts whenever its investment problem becomes difficult. But the life insurance business once expanded continues to produce a stream of premium income likely to flow for a substantial period of years. Since 1940, group annuity plans by large business concerns have created another set of contracts, the premiums for which promise to add large amounts to life company assets. Something of the effect of this new business is hinted by the asset growth of the Teachers Insurance and Annuity Association, which serves only the relatively small group employed by universities. Its assets, chiefly from deferred annuity premiums, have risen to a quarter of a billion dollars in about three decades

and placed it among the two score largest American companies. For all life companies the annual volume of annuity premiums has risen from $386 millions in 1940 to $799 millions in 1948.[9]

5. The figures for the Series E bond changes are included for those who would like to include them in their thinking as an additional savings institution.

6. The influence of the government agency and trust funds shown separately in this table has already been reflected in the reduction of the publicly-held federal debt shown in Table 5. If the reader chooses to think of them as a source of funds in the investment market, he will note their contribution ranks close to that of the most important of the institutions, the life insurance companies, in the postwar period.

Bearing Upon Market Outlook

In using the figures presented, attention is likely to center upon 1947 and 1948 because of the special temporary factors influencing the federal debt in 1946. At first glance the combined demand for long- and short-term funds seems so in excess of the institutional supply as to show heavy dependence upon a supply of funds from individual and other investors not accounted for here. The demand items totalled $10.7 and $10.3 billions against an institutional supply of $7.0 and $6.1 billions in 1947 and 1948, respectively. The gap is eliminated, however, if expansion of Loans and Discounts, other than real estate loans, is deemed to be largely over on the ground that inflation and most of the rapid postwar current asset expansion is past, and that new bank lending will consequently be largely balanced by repayments in the near future. Slow expansion tends to be cared for by retained earnings. Elimination of this money market demand would leave a net demand in the mortgage and bond fields of only $4.5 and $6.5 billions or $2.5 billions less than the institutional supply in 1947 and $.4 billions in excess of it in 1948.

The outlook for rising long-term interest rates, ordinarily associated with boom conditions, would consequently appear small so far as they are determined by these factors, which were dominant in the 1920's. The prospect would be one of prolonged low rates such as characterized the British capital market in the latter part of the nineteenth century, especially the three decades between 1880 and 1910. The Federal Reserve problem would then become

[9] As reported by Institute of Life Insurance in personal correspondence.

one of restraining a rise in bond prices rather than the reverse. Should such a situation appear as more than temporary, the artificial supports to the bond market in the postwar years may come to appear more as a "stabilization" policy rather than a highly artificial and uneconomic price peg. An unnecessary drop and recovery in the bond market will have been "ironed out".

The catch in such prognostication lies in the immensely greater difficulty in predicting the federal influence as compared with that of private institutions. We lack experience with conditions where the federal budget and debt have both reached such a large relative magnitude in the economy. No parallel can be found for expenditures indicated in the field of social security, veterans' aid, farm price supports, foreign aid, and military responsibilities, which seem likely to exceed anything in our previous experience. The influence of federal agency investments has been mentioned as one of these new factors, which is sometimes overlooked and yet it was most important in offsetting, at least partially, what would otherwise have been the inflating force of Federal Reserve bond market support operations. The effect of postwar drives to sell governments is harder to decide, since no one can be sure how much they increased total savings and how much they merely diverted them from other channels.

Speculation about the future effect of the federal budget upon the investment market is beyond the scope of this paper, but some of the main elements may be mentioned to indicate why it should be stressed. Any recession is expected not only to result in a deficit in the ordinary budget, but to reverse the flow of funds to the social security funds. Aid to farmers may reach the multi-billion dollar level. Public works and housing ventures are other possible large items. A "dividend" disbursement on national service life insurance scheduled for early 1950 is expected to run in excess of $2.5 billions.

Such items must be read against the background of a Congress that has difficulty in bringing the ordinary federal budget into balance under conditions of unexampled prosperity and full employment, which presumably would use any surplus that did develop as a basis for tax reduction rather than debt reduction. When current estimates are made of a $5.5 billion budgetary deficit for fiscal 1950 against the background of Table 7, one gains a notion of the huge impact Treasury operations are likely to have on the

capital and money markets even in peacetime.[10] With a fluctuating factor of such magnitude, the forecasting of "natural" interest rates tendencies becomes much less accurate, if not impossible. Unfortunately, such fiscal operations of a government that talks much of the virtues of economic planning appear likely to be so erratic as to exacerbate rather than mitigate the fluctuations of the business cycle and make much more difficult the job of private planning in both business and finance.

[10] Revised estimate by Budget Bureau on November 1, 1949.

FRANK D. GRAHAM AND THE CLASSICAL THEORY OF INTERNATIONAL TRADE

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The law of comparative cost and the concept of reciprocal demand are a part of the educational background of almost every teacher and practitioner of finance. Indeed, because of their simplicity and the ease of their exposition, they are still frequently advanced as the "true word" in questions involving international trade theory, even though their expositor is fully aware of the more recent formulations of international trade theory. The chief explanation of this incongruity is that most criticism of the classical explanation of international trade has been directed toward flaws in the basic assumption of the theory, rather than toward any defect that might be detected in the internal formulation of the theory itself. As long as the basic assumptions could be accepted, the expositor could be confident of the validity of the simple two-country, two-commodity application of the law of comparative cost and reciprocal demand. He had the assurance of John Stuart Mill that the extension of the analysis to more than two countries and two commodities, and the relaxation of the assumptions of constant cost and costless transport, would have no fundamental effect on the soundness of the conclusions. There, thus, has been a tendency to compartmentalize the theory of international trade into categories of assumptions. If the assumptions of the classical school are acceptable, then the explanation follows the line of Ricardo, Mill, and Taussig; or, another set of assumptions may be taken as closer to reality, and the theory may follow, for example, the general equilibrium approach of Ohlin and Haberler.

For more than two decades, the late Professor Frank D. Graham of Princeton, sought to isolate an internal flaw in the explanation of the classical writers; a flaw of the presence of which he was sure, but the identity of which he was uncertain. In the course of the search for the flaw, Graham engaged in a running doctrinal dispute with the adherents of the classical position in general and with Professor Jacob Viner in particular. Graham and Viner were both students at Harvard during the same period. Both studied under that neo-classical master, F. W. Taussig. Viner subsequently sought to elucidate, strengthen, and verify the classical theory of international values. He attempted to demonstrate either that the major criticisms of that doctrine had been anticipated and answered by one or another of the writers in the classi-

cal tradition, or that such criticism could still be answered with but slight modification of the original position. Graham, on the other hand, was the skeptic. Dissatisfied with the classical explanation of international trade, he constantly sought for the defects in its argument.

In an article "Some Aspects of Protection Further Considered," published in 1923,[1] Graham pointed out the dangers of generalizing from the assumption of constant cost of production. In a subsequent article in the same year, "The Theory of International Values Re-examined,"[2] he analyzed the assumption of two countries and two commodities, concluding that if more than two countries or two commodities are included in the model, the conclusions are quite different from those reached by the classical writers. A third article, "The Theory of International Values,"[3] published in 1932 presented a stronger and more precise statement of his criticism of the concept of reciprocal demand and of the assumptions of two commodities and two countries.

Viner, in his *Studies in the Theory of International Trade,*[4] took cognizance of Graham's criticisms and either dismissed them or gave them what he considered to be adequate answers within the framework of the classical doctrine. Graham was not convinced. His critical endeavors culminated in *The Theory of International Values,*[5] a volume that appeared just a year before his tragic and untimely death. Whereas in 1923 he had written "... the classical theory of international values seems to the present writer to be open to grave objections, objections which, while they do not subvert its foundations, nevertheless call for a substantial modification of its conclusions,"[6] the opening sentence of his latest and last major work states: "The theory of international values here presented is, in form, an elaboration but in fact, a complete refutation of classical doctrines."[7] Graham at last had found what he considered to be a defect in the basic structure of the classical doctrine rather than an error which called only for a modification of its conclusions.

[1] *Quarterly Journal of Economics,* XXXVII, (1928), 199-227.

[2] *Quarterly Journal of Economics,* XXXVIII, (1923), 54-86.

[3] *Quarterly Journal of Economics,* XLVI, (1932), 581-616.

[4] New York: Harper and Brothers, 1937.

[5] Princeton: Princeton University Press, 1948.

[6] Graham, "The Theory of International Values Re-examined," *Quarterly Journal of Economics,* XXXVIII, (1923), 54.

[7] *The Theory of International Values,* p. 3.

Graham found this basic flaw in the classical position in the concept of reciprocal demand. Ricardo had presented the doctrine of comparative cost in simple form, but had left unanswered the question of the determination of the actual terms of international interchange within the limits of the differences in comparative costs. Mill, in what Edgeworth subsequently described as a "stupendous" and "unsurpassed" chapter on international values[8] (a view with which Mill doubtless would have been happy to concur), enunciated the proposition that the terms of trade would be determined by the force of reciprocal demand. Although Ricardo did not have a complete theory of international trade, the theory developed by Mill, nevertheless, stemmed directly from the Ricardian assumptions and analysis.

Mill had indicated that the international value ratio (assuming two countries and two commodities) would be fixed, within the range of comparative cost differences, at the point where the reciprocal demand of each country for the product of the other balanced. Consequently, if demand on either side were to shift, the exchange ratio would be expected to shift to a compensatory degree. This analysis, according to Graham, puts the determination of the international exchange value of goods squarely up to demand, and this amounts to a "market" rather than a "normal" value determination. Inasmuch as the classical economists were primarily concerned with normal rather than market value in their analysis of value in the domestic market, it may seem somewhat strange that they were unable or uninterested in providing a normal value explanation of international trade. As Graham pointed out, "it should never be forgotten that, whereas normal values are a potent and persistent factor in the market, market values have only a remote and intermediate influence, if any, on the norms to which they are steadily attracted."[9] Graham argued that this inconsistency in the classical position and the flaw in its international value analysis occurred because the classical writers (and their followers) accepted the thesis, albeit unconsciously, that changes in the relative values of internationally traded commodities would affect the ratio of exchange, *but would not affect their relative supplies.* Supply was inferentially assumed to be *fixed,* precisely the requirement, of course, for supply in a discussion of the determination of value in the market period. Had it been

[8] John Stuart Mill, *Principles of Political Economy.* Ashley edition. New York: Longmans, Green and Co., 1871 (reprint 1929), Book III, chap. XVIII.
[9] *The Theory of International Values,* p. vii.

recognized that a shift in reciprocal demands can, and is likely to, affect the supplies of the traded commodities, Mill's conclusion, cited above, would have been applicable only to the conditions of a very special case, rather than, as he considered it to be, generally applicable.

The error of presuming fixity of supply gave rise to subsequent errors throughout the classical analysis. Particular goods came to be identified with particular countries. Inasmuch as each country was presumed to be both specialized in one commodity or in an exclusive category of commodities, and to be producing as much of its specialty as possible, it followed that the analysis of adjustment to disturbances of international equilibrium ran in terms of a shift in the price relationship between a country's exports and imports, rather than in terms of the volume and composition of the country's trade. Shifts in the price relationship between imports and exports are shifts in the "terms of trade." Classical analysis placed great emphasis on the terms of trade, as if trade were conducted by national entities rather than by individuals. A shift of demand was interpreted and analyzed in terms of a shift in demand of a nation for the goods of another nation, rather than as a shift in the demands of individuals, wherever located, for products, wherever produced. Thus, the method of treating international trade was quite different from that applied to competitive trade among individuals, although the latter was emphasized by the classical writers in their discussion of domestic values.

Graham's objective was more than that of simply pointing out the flaws in the classical analysis. His purpose was to construct a system which would present a theory of normal values in international trade, but which would still be based on the classical assumptions. In the process of this construction, he pointed out his specific differences with the classical theorists. He used Mill's well-known illustration in which the incurrence of a given amount of cost will

produce in England	*produce in Germany*
10 yards of broadcloth, or	10 yards of broadcloth, or
15 yards of linen, and	20 yards of linen

With the familiar assumptions of two countries and two commodities produced under competitive conditions of constant cost, Graham started by supposing that trade begins at one of the limiting ratios of the comparative cost relationship. He supposed that trade starts at the ratio of 10 cloth = 15 linen, the limiting

ratio in England. At this ratio, it is clear that English producers are at the margin of indifference as between cloth and linen. Their returns will be no greater if they produce one than if they produce the other. In Germany, on the other hand, all production will be concentrated in linen, for, at the ratio of 10 cloth to 15 linen, it will be advantageous for producers to make the latter but not the former. Under what conditions would this ratio be a stable ratio? It would be stable if the total demand for linen in both countries taken together were so great that Germany, completely specialized in linen production, could not produce enough to supply it. Under these conditions, the ratio would come to rest at the point where a sufficient supply of linen would be forthcoming to meet the demand. This would be the ratio at which English producers also could produce linen, as well as cloth—England's cost ratio of 10 cloth = 15 linen.

Graham then supposed that the demand for cloth should rise relative to that for linen to such an extent that English producers could not meet it even after they had shifted completely out of linen production and into the production of cloth. The ratio would then have to shift so as to evoke additional supplies of cloth from German producers. That ratio would be 10 cloth = 20 linen, the cost ratio for Germany and the margin of indifference for German producers. At this ratio, England would be completely specialized in cloth and Germany would produce both cloth and linen. A considerable shift of demand toward cloth, however, could take place before the ratio of exchange would shift in favor of cloth, because of the possibility of shifts in the output of producers on the margin of indifference in England. When the shift in the ratio finally occurred, however. it would be all the way to the cost ratio of the other country. At any intermediate ratio (where, indeed, the principle of reciprocal demand had insisted that the ratio would ordinarily be established), the producers in neither country would be at the margin of indifference, and the additional supplies of one or the other or both commodities would shift the ratio. The actual barter ratio between cloth and linen could be stable at some point in between the two limiting cost ratios only if there were the "simultaneous elimination, in each of the trading countries, of the industry which is, to it, of comparative disadvantage."[10] This could happen only if, with each country completely specialized, the total maximum supply of the product of its comparative advantage

[10] *Ibid.*, p. 32.

exactly matched the total demand for the product in both countries at such an intermediate ratio. Common sense suggests that such a case, far from being the usual one as contended by Mill, is so unlikely as to be all but unimaginable. Actually, any intermediate ratio would be highly unstable. Stability could be attained only at one or the other of the limiting cost ratios.

When Graham extended his analysis to include more than two countries, he concluded that the barter ratio between the two commodities would probably settle at the cost ratio of some intermediate country (that is, at the cost ratio of some country whose ratio was somewhere in between the extreme cost ratios), especially if that country were one with large productive capacity. With the producers in a large country at the margin of indifference, shifts in demand would induce shifts in the relative supplies of the commodities, but only extreme demand shifts would evoke a change in the barter ratio. When more than two commodities were included, the ratios would fall at the cost ratios of one or another of the countries that produced at least two of the commodities in question. Thus each commodity would be produced at the margin of indifference in some country. Each country would produce at least one commodity which was also produced in another country. These common commodities would tie together the cost structures of all the countries.

Graham went on to apply his method to several of the problems that interested classical and neo-classical writers. A *shift in demand*, he concluded, would have no effect on the ratio of exchange unless it were so drastic as to shift the margin of indifference from one country to another. Should this happen, it would be impossible, a priori, to determine its effect on the distribution of the gains from trade. It might be possible that a decline in the demand for the goods exported by any given country might increase as well as that it might decrease that country's income and gains from trade. *Costs of transport*, according to Mill, would be divided between trading countries on the basis of the "play of international demand."[11] Graham contended that transport costs would almost always be borne solely by the importer, since production in the exporting country is at the margin of indifference, and the necessity of paying transport costs would induce a shift of resources to other lines of employment and output. While the older classical writers had asserted that the *introduction of money* into the

[11] Mill, *op. cit.* p. 589.

analysis of international value would have no effect on its conclusions, Graham averred that this position would be correct only if the money were a non-commodity credit money, a type of money which the classical writers would hardly have advocated. If the money were a commodity, then its cost would have some bearing, however slight, on the whole constellation of costs and therefore on the ratio of exchange.

Because of their method of attributing the ratio of international exchange to be the result of the status of recripocal international demands, the classical writers were moved to speculate about what would happen to the terms of trade if a *change in demands should develop spontaneously or be provoked by governmental action.* They considered the effects of improvements in productive techniques, the imposition of tariffs, the entry of new countries into trade, capital flows, and similar problems. Graham concluded that the classical analysis leads to as many wrong conclusions as right, that it is largely accidental when its conclusions are correct, and that it is almost impossible for a country to consciously manipulate the terms of international exchange as long as competitive assumptions are fairly descriptive of market conditions.

The net effect of Graham's positive construction is to reconcile the method used by the classical school with the conclusions reached by the general equilibrium analysis of Ohlin as long as the same competitive assumptions are made. In other words, if the classical economists had followed the method laid out by Graham rather than the one they did, there would have been no difference between their conclusions and those of the general equilibrium economists, except for those differences that result from dissimilar structural assumptions. Graham has performed the valuable service of putting his finger squarely on the classical error and of tracing that error through some of the ramifications of the classical analysis.

The Theory of International Values was not intended for, and was not written for, the general reader. The method of extending the two-country, two-commodity arithmetical approach to as many as ten countries and ten commodities simultaneously makes for an exposition that is extremely cumbersome and unsuitable for holding the attention of any except those actively interested in the theory of international trade. Nevertheless, it is the opinion of the present writer that everyone who deals with problems connected with the theory of international trade should read the first two and the concluding chapters of the book. The entire book merits careful study by the specialist.

A NEW SUPERVISORY VIEW OF BANK CAPITAL

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The Comptroller of the Currency apparently has adopted a new policy with respect to bank capital. There was no formal announcement and the change came to public attention by accident. At first the change was officially minimized. The Comptroller seemed disposed not to regard his capital policy as altogether "new". But whether the policy was truly "new" or only a natural evolution from prior policies is of only academic interest. The practical effect is to change materially the emphasis in bank capital management. The change represents in the opinion of many a welcome development in the course of general bank supervisory policy.

The first public attention to the new policy came when midwestern financial papers started checking reports that the supervisory agencies were pressing for capital increases. At first it was reported that capital additions were being requested according to the formula: one part of capital to six parts of risk assets. Risk assets were defined as all assets except cash and United States government securities. Later it developed that there was no rigid limiting ratio: one-to-four and one-to-seven, both were mentioned. Even later it was made clear that there are no exact limits. The ratios are used only as a screening device.

A letter of inquiry[1] to the Comptroller of the Currency elicited an admission that there was indeed a new capital policy. The letter of reply said in part:

"It is true that we have asked some national banks to strengthen their capital structures . . . but we do not use any mechanical or fixed standard or ratio for gauging the adequacy of capital structure. We firmly believe that it is impossible to arrive at a uniform standard or ratio which will be applicable to even a few banks, because every bank is different from all others with respect to the quality of its management, the quality and nature of its assets, and the manner in which it conducts its business."

The letter went on to emphasize that ratios were used only as a screening device and to stress the role of qualitative factors in

[1] From Sam Lyons, editor of *Finance* and replied to by J. L. Robertson, Deputy Comptroller of the Currency. The exchange was reported in the May 31 issue of *Finance*, p. 15.

bank management and their influence on the amount of capital needed. The letter said:

"... we use ratios purely as preliminary indicators of cases which appear to warrant close study to determine whether an apparently slim margin of capital structure in relation to risk asset volume is, in fact, an inadequately capitalized position.

"In actually determining whether supervisory action is called for ... we give very careful study to such factors as competence and objectives of management, quality and volume of assets, earning capacity, dividend policy, and the general economy of the area in which the bank is operating."

Later in the year when the Comptroller's Annual Report for 1948 was released, there was a repetition of some of these ideas, together with an enlargement on the background philosophy. The report said:

"Up to less than a quarter century ago there was a general feeling that, subject to exceptions, a ratio of $1 of capital structure to $10 of deposits was about "right" — that a lower relative capitalization was dangerous and a higher capitalization usually unnecessary. It is believed that this principle was based on an economic system in which most of the available funds of commercial banks were fully utilized, for substantial periods, in their lending activities. In other words, a 1-to-10 capital-deposit ratio might generally be tantamount to a 1-to-5 or 1-to-7, for example, ratio of capital to loans plus investments other than federal government obligations.

"In the circumstances described, a capital-deposit ratio was a useful rule-of-thumb, for it was actually merely an indirect and rough method for gauging a relationship of a bank's capital cushion to the amount of its loans and investments necessarily and properly involving an element of banking risk. Today, capital-deposit ratios generally lack this validity and justification as tools for bank supervision. The rapidly changing character of bank assets, adverted to in this and previous reports, is such that the ratio of capital to deposits is not a reliable measure of the magnitude of the *risk* element in the banks' activities, and it is the function of the capital structure to protect the bank and its depositors from that element of risk ..."

Most observers of banking affairs had long recognized that the traditional "one-to-ten" rule of bank capital has lost much of its force and meaning. The vast changes in the composition of bank

assets and the greater variations from bank to bank in the qualitative character of assets had robbed the old standard of much of its merit.[2] But until some sort of replacement had been adopted there was a most understandable tendency on the part of bank supervisory agencies to fret about capital adequacy and, lacking a new basis of testing, to revert to the old one.

Another change, though a less readily discernible one, has been toward accepting aggregate bank capital as reasonably adequate. While it is hard to document this assertion with chapter and verse, the Comptroller's 1948 annual report reflects far less alarm about bank capital than earlier reports. Inadequacy of capital in specific banks is averred, but a general inadequacy of capital is not asserted. This view follows naturally when bank capital needs are measured by asset risk rather than as a crude ratio to deposits. The old capital-deposits standard was a purely quantitative measure; asset risk as a standard also gives weight to qualitative factors as well. If the new standard for capital needs has led to less alarm about aggregate bank capital inadequacy, it has already done a great deal of good.

So far there has been no indication of a change of policy by the other supervisory agencies. Indeed there were rumors that the Federal Deposit Insurance Corporation was continuing to apply the older capital-to-total-resources ratio, but that it was now asking a restoration of capital on a one-to-fifteen basis rather than on a one-to-ten basis.[3] A speech by the chief examiner of the Federal Deposit Insurance Corporation indicated some sympathy for the Comptroller's view, but not exactly a change of heart. His observations indicated the difficulty of using rigid rules of capital determination. He closed his remarks by saying:

"... we cannot ignore the fact that the capital structure of the commercial banking system cannot survive an asset shrinkage of more than 6.7%. Whether 6.7% or 10%, or even 15% represents an adequate capital ratio is a moot question that I will not attempt to answer. In my opinion the banking system as a whole can claim to have attained a proper capital position if each of its

[2] A detailed history of supervisory policy with respect to bank capital and criticism of it as the basis for supervisory policy may be found in my article "The Capital-Deposit Ratio in Banking Supervision," *Journal of Political Economy*, XLIX, (Feb., 1941), p. 41.

[3] Harry Adams, "Agencies Press Banks for Higher Capital Ratio," *Chicago Journal of Commerce*. (May 20, 1949).

members provides a capital structure in keeping with the needs and risks of the community and clientele which it serves."[4]

This admission is qualified by an air of reluctance to adopt a new rule, even if the old one is outworn. At an earlier point in the speech he said:

"... if we measured capital against risk assets at the time when cash and governments were at their all-time peak and decided that capital structures generally were ample, we overlooked, or ignored the fact that the return of banks to lending on a scale hitherto unknown would boost asset risks much faster than normally possible for bank capital to match them. That fact has been proved mathematically by the drop in the ratio of capital to risk assets while the ratio of capital to total assets has shown a healthy increase."

The 1948 annual report of the FDIC seems to show even less sympathy for the "new" view. In discussing the capital of insured banks it said: "This growth in capital is encouraging, but it is not a satisfactory rate of increase in view of the change in the character of bank assets which is taking place and the normal rate of growth in bank operations" (p. 4).

This sounds as if the FDIC believed that bank capital is generally inadequate. But their report recognizes the fact that capital needs are related to the character of assets. Indeed at a later place the report paid its respects to the concept of risk assets. It said: "... to maintain the present amount of bank capital relative to those assets commonly designated "risk assets" will require larger additions to capital than the banks have been making in recent years" (pp. 4, 5).

But still later the report reverts to a standard that is very much like the old capital-deposits ratio. In this modified standard the capital of the banking system is added to the insurance fund of the FDIC and the total is compared with deposits. This is a statistical refinement, but it does not escape the basic flaws of the capital-deposits standard.

It does not appear that the Comptroller's capital standard has been adopted by any of the state banking departments. In the responses to the Douglas questionnaire the state bank commissioners

[4] Speech by Vance L. Sailor, Chief of the Division of Examination before the Vermont Bankers Association, spring of 1949.

indicate no such view. Indeed, two bank commissioners disclaim any responsibility for the amount of banking capital.[5]

How Appropriate Is the New Bank-Capital Standard?

Even if the displaced capital-deposits standard had many flaws, how appropriate is the new standard? Does it have undisclosed faults and will it prove to be defective? So far no serious flaws are evident. On almost every score this change appears to be a welcome one. The old capital rule was obviously untenable. It had not been wholly unworkable under prewar conditions, but even then it was far from truly satisfactory. But the war exposed the weaknesses that had long been noted by those who had studied the matter in earlier periods.

And getting rid of a bad rule is progress even if the replacement has flaws. The evolution of supervisory policy almost inevitably means that there are such halts and skips. The present rule has not been in operation long enough to disclose its operating flaws; we can only speculate on it in a very general way.

One minor flaw might be anticipated. The nature of risk assets varies so widely that the range of needed permissible capital-risk assets ratios may be so wide as to be meaningless. While there are no indexes of implicit risk, some wholly acceptable bank assets involve many times more risk per dollar of funds than other types of "risk" assets. The technique of actuarial evaluation of risk is not applicable until more empirical work has been done. The FDIC has made some comparative studies of bank assets but the results of these studies have been published only in part.[6]

The new capital rule has brought with it another welcome change —an explicit admission that general policies of the supervisory agencies are matters for full public debate and disclosure. In the Comptroller's letter to Lyons, he said:

[5] *Monetary Credit, and Fiscal Policies*, a collection of statements submitted to the Subcommittee on Monetary, Credit, and Fiscal Policies by government officials, bankers, economists, and others (Joint Committee on the Economic Report). A. A. Rogers, Superintendent of Banks of the State of Oregon, said: "It is my opinion that the Federal Deposit Insurance Corporation may be encroaching upon management when they talk about capital funds in a problem of management. . . . " J. F. McLain, director of banking in Nebraska, said: "None of the reports of examination in this State offer suggestions for increases in the capital structure, especially none for increasing the basic capital stock. . . ." (p. 381).

[6] For example, The *Annual Report of the Federal Deposit Insurance Corporation for* 1944 (pp. 134-37), published summary tables of examiners' appraisals of bank assets.

"We operate on the principle that being a governmental agency, our views and policies should be definite—wherever possible—and clear, and available to all who wish to be informed of them.

"It is for that reason that we attempt to operate in a goldfish bowl, so to speak, as far as possible. Our views concerning any particular institution, of course, are never discussed with persons other than those directly connected with the bank. . . ."

In the past the capital policies of banks have not been very adequately or fully discussed by the supervisory agencies. In their reports affirmations of the old one-to-ten standard have appeared from time to time but comment as to how literally they expected this standard to work and how vigorously they were pressing for additions to banking capital were infrequent. Often the nature of supervisory policy then being practiced had to be winnowed from the gossip of bankers—a tedious and not wholly dependable way of getting at important public information.

While the new capital rule of the supervisory agencies has much more logic and merit than the one it displaced, there is one further flaw, one that may be corrected in time but which seems to be aggravating the introduction of the rule.

Public regulation should depend on clear and explicit rules. "Speed limit: 20 miles per hour." ". . . shall not be more than 10 per cent of unimpaired capital and surplus." "Net taxable income as determined in schedule A and shown on line 10c." The former rule with respect to capital—the several variations of the one-to-ten rule—had the merit of being explicit. Each banker knew how he stood; he was within the prescribed limit or he was not.

The new rule seems to lack clarity. While it is clear enough in one way, could the average banker tell before visitation by the examiner just how he stood? And is the new rule one that can be twisted by a bad-tempered examiner to give vent to his pique of the moment? Is each bank to be told into which category it fits? Is there to be some fairly unambiguous basis by which a bank could test the justice of having to observe a stiffer rule than that applied to some nearby competitor?

Government by law is less flexible than government by administrative discretion, but in the long run it is safer.[7] Where the

[7] The bible of those who believe this is still "Rules versus Authorities in Monetary Policy" by the late Henry Simons. First published in the *Journal of Political Economy* in 1936, it stands up remarkably well under renewed reading. It is now readily available in *Economic Policy for a Free Society*, a reprint of Simons' articles edited by Aaron Director and published by the University of Chicago Press in 1948.

limits of judgment are so ambiguous as to make rules impracticable we might have to forego the advantages of the clear and explicit rule, but this does not seem to be one of such cases. Banking supervision has many problems, but there are objective grounds by which classification of banks and spelling out of rules becomes possible.

If the rules of supervisory procedure cannot be spelled out, full exposure of general supervisory policy becomes even more important. In this sense the promise of fuller publicity to policy is a forward step. But there are other possible improvements. Present examination report forms have little to say about bank liquidity (except for checking the maintenance of legal reserve requirements). But many bankers report that examiners often comment extensively on liquidity policies orally. Here is a factor that may have more influence on the safety of banks than capital and yet it is left to informal and oral treatment!

One aspect of the new standard has been deliberately neglected here: Is this standard more or less consistent with the needs of credit and monetary management than the one it displaced? There is nothing immediately evident which would indicate a preference either way. Capital regulation could be tied to credit regulation but there is no necessary connection and none in our system of legal bank supervision.[8]

Does Supervisory Policy Make for Static Banking?

Welcome as these changes in bank supervisory policy may be, the occasion can be used appropriately to inquire about the general effects of present banking supervisory policies. Are they producing the kind of banking and the kind of banking system we want? In what direction are they leading the evolution of commercial banking?

History shows that governmental intervention in banking came as the result of developments which the public believed to be intolerable. When bank organization was being monopolized by those

[8] Capital is used as a kind of credit regulator in at least one case recently brought to light. Italian commercial banks cannot expand loans and discounts beyond 30 times net capital account. This rule, originated in 1926, was not applied for a long period but it has been recently reactivated by the Bank of Italy. It seems to be used in lieu of cash reserve requirements as a means of limiting total bank credit expansion. See Bruno Foa, *Monetary Reconstruction in Italy*, (King Crown Press, 1949), p. 106. For a general treatment of the relationship of supervision and monetary policy see G. L. Bach, "Bank Supervision, Monetary Policy, and Governmental Reorganization" in this *Journal* (December, 1949), pp. 269-85.

with legislative influence, we soon had free banking. The abuse of note issue privileges led to limitation and finally prohibition of private note issue. The system of reserve requirements was an effort to stem banking collapse in times of money panics. The rise of the discretionary bank supervisory authority was almost always the result of weakness in the banking system. At present our newest and probably the most powerful of the banking supervisory agencies, the Federal Deposit Insurance Corporation, is largely the product of banking difficulties during the early 1930's.

Since bank supervision was created to cure evident evils, its shape has been negative—aimed at the elimination of old abuses. But in the formation of public policy there is every reason to urge that it be positive and forward looking. Generals are accused of preparing to fight the last war; economists advocate public policy to counteract economic difficulties like the most recent difficulties. By the same token banking supervisory policy can often be accused of trying to cure the weaknesses of the most recent period of trouble.

When banking supervision was being established there were frequent evidences of banking weakness due to overrapid promotion and expansion. Banking is a business in which there is a very real danger of such rapid development.

Mr. J. W. Beyen, a shrewd observer of banking affairs and himself both a commercial and central banker, has said:

"In the mind of the detective-novel reading public, bankers are both very clever and very wicked. With very few exceptions they are neither. They are, mostly, good meaning citizens of average intelligence, carrying out a profession along traditional lines. . . .

"Only exceptionally few bankers belong to the class of creative *entrepreneurs*. The banking world as such is populated by a large majority of *routiniers*—just as is every other profession—that has to earn its living by its day-to-day work. They have a strong tendency to walk in step with their fellow bankers, as this is the only way not to lose business nor to get into financial trouble."[9]

Later, in commenting on the troubles of the infamous Darmstadter Bank in 1931, he diagnosed their trouble as having been overpromotional banking. He noted no banking malpractices aside

[9] *Money in a Maelstrom* (New York: Macmillan Co., 1949), p. 41. This quotation and the following one are reprinted with permission of The Macmillan Company.

from this; nevertheless it was enough, in his opinion, to break the bank. He said:

"A bank that extends its business faster than its competitors by being easier in the granting of credits is bound to become less liquid. The leading bank during a boom—often a bank under the leadership of a man who is more a financier than a banker—is the first to get into trouble in the depression.

"Deposit banking is, in a way, a boring profession because it pays to be cautious. An imaginative leader, and more especially one who likes to gamble, will not easily resist the temptation during a boom to extend his business, to grasp chances of profit. . . .

"When finally the situation becomes untenable, the former leader will be deposed and blamed as a gambler. People that flattered him during the days of his glory will look down on him and decry him as a criminal . . . . . But the verdict they get from public opinion after their downfall is usually as unjust as all verdicts of public opinion are. They (the creative bankers) quite often had a creative genius that refused to stay within the limits drawn by the principles of sound finance. In nearly all countries there are prosperous businesses . . . that would never have come into existence had the creative spirit of a banker not induced him to walk out of step."[10]

But does an excess of promotion characterize our present banking scene; do we suffer from overpromotional banking? The very tone of the question almost suggests the answer. Banking has become one of the most cautious of businesses; it would be hard to find one less given to risk-taking.

And, of course, to recognize the wisdom of Beyen, there is much merit in this—within reason. Avoiding a too forward position in the band wagon of development is desirable. The evil of overpromotional banking was real, and we should be glad to be rid of it. But have we gone too far; has banking been forced into a mold so rigid that it is not fulfilling its functions and may be inviting its ultimate displacement?

This is not a rhetorical question nor an imaginary danger. However superfluous most government lending activities may now seem, there are few of these activities that were not first promoted when there was a widespread feeling that private lenders—with commercial banks particularly singled out for criticism—were failing to provide credit on terms which the community thought

[10] *Ibid*, pp. 52-53.

just. Recently the banks have gone as far in meeting the credit needs of the business community as anyone could ask. But will this policy persist? Will banks stand by their marginal customers when the next great depression emerges?

If the over-all character of the banking system is perhaps more cautious than is in keeping with a viable banking system, should the supervisory agencies keep on singing the same old theme song, "too little capital and too much risk," even if they have revised the tune a little? This is an extraordinarily difficult question because supervisory authorities will never earn any medals for promoting active banking that fulfills its business and economic responsibilities. But if the system fails, they will be intemperately criticized. So their personal reasons for not wishing to take chances are understandable.

But this is precisely the sort of incentive situation that has made the business of banking a more static one than it once was. The banking "promoter," the man who organized and developed banks and became sometimes a "chain banker" has almost disappeared. The active management of many banks has passed from the hands of those who own a majority interest into the hands of more professional managers.

But what are the incentives of the professional bank manager? In the first place he must get along with his owners, he wants no criticism which might upset them or weaken their confidence in him. As a result, the confidential report of the bank examiners, delivered directly to the directors, may have more influence than before. A promoting owner might face the examiner and challenge him; he might (and apparently often did) disregard examiners' criticisms and suggestions. But the professional manager can seldom afford to take such a stubborn attitude; if he wants a job and a raise, he finds it expedient to forestall the examiner's adverse criticisms before they are ever made.

And what are the other motives at work on the professional manager? He wants his bank to succeed as well, possibly a little bit better, than similarly located banks. The margins he seeks are small ones: a little larger deposit gain than competing banks, a little more profit. But can the professional bank manager afford to get out in vigorous development of new business that carries with it more than average risk? In most cases there is almost no advantage to such promotion. If the new business pans out well, the owners reap most of the profit; the manager's own bonus or

salary adjustment is likely to be modest. But if it pans out badly, it may cost the manager his job and possibly his career in banking.

This sort of stultifying influence is all too often to be found not just in the professional bank manager in the moderate-sized bank, but also pervading many larger banks. How does one get ahead in a banking career? Is it by vigor and aggressiveness in business activity? It is sometimes, but not as often as it should be.

These problems, of course, go beyond the sphere of supervisory influence. But the nature of supervisory policy needs to be adapted to the changing character of the institutions being supervised. They need to be something of a balance wheel. When an era of overpromotion exists, they need to curb banking in that direction. But when some part of the banking system shows alarming signs of paralysis, the weight of supervisory influence certainly should not be on the side of caution; it should, so far as possible, run in the opposite direction.

Here is a question for the supervisory agencies: how often have they included in their examination reports a criticism of a bank for failing to take advantage of legitimate lending opportunities and of meeting proper loan demands?

The Public Utility Character of Banking

The responsibility of the supervisory agencies for the encouragement of aggressive banking is all the greater now that the banking structure has become rather fixed. When, in long passed days, a bank did not provide the kind of loan service that an important segment of the community thought it merited, the answer was to organize a new bank. While this doubtless led to over-banking in many cases, it did provide a steady incentive for banks to meet their responsibilities.[11]

But we no longer have this safeguard. The supervisory rules which govern the organization of new banks or the establishment of *de novo* branches tend to allow new offices only in non-competing areas. While in most urban areas there is active competition, the degree of competition in many smaller cities and towns is much less. And it is precisely in such places that bank credit can play such a vital role in the success of business concerns. The position

[11] See, for example, the observation on bank chartering in "Supervision of the Commercial Banking System" by Robert T. Leonard, in *Banking Studies*, (published by the Federal Reserve Board of Governors, 1941), p. 198.

of importance and prestige possessed by the banker in moderate-sized and small towns is not an accident.

There have been many individual illustrations in recent years of the influence that an aggressive banker can have in these moderate-sized communities. When more or less dormant banks have passed into new and aggressive hands, the results in community development have been evident and therapeutic. A good banker can make a great deal of difference to the community in which he is the leading financial figure.

But if the banker plays an important role, the supervisory agencies should be on the side of encouraging a generally beneficial use of this role. The goals of banking supervision must run beyond the "soundness" of their individual institution and simple rules of safety; they should comprehend the encouragement of sound developments in the banking system as a whole.

It would be unfair to banking supervisors if we did not recognize the problems on the other side. A generation of bank failures led to the general belief that we could not afford waves of bank failures. The methods for avoidance of failures have met with such complete success that bank failures have all but disappeared. While the period of test has been one favorable to banking, there is every reason to think that the system is so strong that it could withstand a deep and prolonged depression without serious banking difficulties.

But having decided not to let banks fail, we have foregone the usual corrective measures for overaggressive promotion. We let almost anyone start a grocery store if they want to—and we let them fail if they cannot make a go of it. But since we have foregone the discipline of failure in banking, there has been substituted a limit on those who can start banks and "going concern" supervision to keep the operating institutions from going too near to the brink of failure.

The analogy of banking to public utility operation becomes surprisingly close. Franchise rights are limited, operations are closely regulated, service rates are controlled, and continuity of service is guaranteed.

But the public utility analogy has still another application to our inquiry. One of the basic responsibilities of those who seek a public utility franchise is to make the service of the utility available to all who apply. In practice the administration of this rule

is limited. But the service responsibility is a corollary to the franchise right. So might it be in banking; if banks are to occupy a sheltered position, then responsibilities go with this privilege. And the supervisory agencies should be interested in the discharge of this responsibility as they are in the maintenance of financial prudence under their jurisdiction.

Timid Banking, Aggressive Banking, and Promotional Banking

We should be less than candid if we did not admit that this is a touchy problem; that urging banks to be more aggressive may be carried to an extreme. Banking is one of those in-between businesses in which the margins between timidity, aggressiveness, and promotion are hard to define. The father who urges his son "not to be afraid but to jump into the water and swim" is probably paralleled just a few yards down the beach by a father who is earnestly telling his son that "if he catches him going out beyond his depth, he will tan his pants!" And both fathers are right, of course, in their respective injunctions.

The question then is just how bold or how timid are banks? An increasing number of banks seem to have recovered fully from the atrophy of the early 1930's and to have become active and aggressive credit grantors. The protests of inadequate credit sources are no longer so often heard. But will this revival outlive the present period of prosperity; will the banking system recede into a fear and panic if times turn bad; will liquidation banking again prevail? And the question we are asking here more particularly is: do the standards of the supervisory authorities encourage a type of regressive action on the part of banks which is not in keeping with the long-term interest of the community or of the banking system itself?[12]

What To Do About It

The supervisory authorities might concur in much of what is said here but nevertheless ask what could they do about it. The supervisory position is both traditionally and legally such a negative one that the promotion of positive ideas as to the directions that banking should take seems outside their powers and responsibilities.

[12] Lewis Froman has addressed himself to the need for more aggressive bank lending but seemed to conclude that more bank capital was needed if banks were to lend more freely. This can be disputed. See his article "The Adequacy of Bank Equities," *Journal of Finance*, II, (October, 1947), p. 28.

This is a just rebuttal. Much of the static nature of banking grows out of the nature of the business. Too much risk-taking is as bad as too little (and often looks a lot worse). In a world in which the financial community is often made the scapegoat quite unfairly for all sorts of remote evils, the advantages of prudence and inaction are evident. Banking, like the military services in peacetime and the bureaucracy, has a congenital tendency to "take it easy."

But even though the supervisory agencies should not be expected to cure the faults of which we speak, they can stop aggravating them. A few fairly specific steps that can be taken are:

1. More attention can be given to credit-granting practices and less to the results of individual loans. This has the advantage of being preventive rather than remedial medicine. Some very skilful bankers can make loans—and collect most of them—under circumstances that would ordinarily seem hazardous. This is skill in credit-granting and deserves the highest kind of praise. The credit-granting and protecting devices used by these bankers deserve wide use. On the other hand, examiners have been known to criticize credit-granting results that were unfortunate for reasons even the most foresighted of bankers could not have anticipated.

2. The examiners should give more attention to liquidity policies. Studies of bank closings show that lack of liquidity was almost always the factor which precipitated failure. Most banks are now very liquid but this may not continue to be true. This factor is as appropriately a matter of supervisory interest as is bank capital.

3. There should be little praise for the do-nothing banker. It has often been pointed out that the banker who brags of having suffered no credit losses or very small ones is probably admitting to have turned down many fine and deserving credits. Examiners should take what might be called an actuarial view of banking losses. As long as losses are kept within prescribed limits, the lending procedures and operations are satisfactory. (Since fluctuations of economic conditions tend to bunch losses, this variable should have to be admitted to the scheme of actuarial appraisal.)

4. The commercial banking structure is uniquely fitted for the granting of local credits; as an institution of investment in the open markets, it has no advantages and some disadvantages vis-a-

vis other institutional investors. While the credit standards of loans and of open market investments cannot be compared precisely, it is arguable that banks should be held to much higher credit standards for investments than for loans. They should not take risks where they have no such special advantages.

5. The role of the field examiner should be made that of a fact finder. This has already developed some distance but the policy should go farther. The less the field examiner operates as a discretionary agent, the more our goal is achieved—supervision by rule and not by authority.

But is is ungracious to use an event of progress as an occasion for raking over old quarrels. The change of policy by the supervisory agencies, even though forced on them by events, is a move in the right direction; possibly a harbinger of further advances.

FISCAL POLICY IN JAPAN

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For the first time in almost two decades, as a result of a program prescribed by Mr. Dodge, president of the Detroit Bank, Japan has a balanced budget. For some eighteen years previously Japan had undergone uninterrupted deficit financing with ultimate disastrous consequences. Now without repudiation, without currency conversion, an interesting and effective stabilization program has been undertaken.

The nadir of the great depression in Japan was reached in the last quarter of 1931, and thereafter the economy expanded. April, 1931, saw the advent of deficit financing; September, 1931, marked the beginning of the Japanese occupation of Manchuria. The gold standard was finally abandoned in December, 1931. Takahashi, finance minister from 1931 to 1936, who has sometimes been called the "Japanese Keynes," advocated deficit financing as a way out of the depression. He regarded 600 million yen as a safe limit for deficits but the militarists needed more for the China campaign they were planning. Takahashi was assassinated in 1936 for resisting further military expenditures, and thereafter the deficit rose. The sharp growth in military expenditures in the 1930's provided an inflationary fillip which greatly stimulated the economy. The total Army-Navy budget rose from 434 million yen in 1931 to 7,261 million yen in 1940. Army construction funds alone in 1937 were one and a half times the entire 1931 Army budget. The military budget which was 29 per cent of total expenditures in 1931 rose to 65 per cent in 1940. In 1937-38 the budget deficit rose to 1.5 billion yen. In 1940-41 it was up to 6.9 billion yen.[1]

When pressures mounted during the war period, 1937-45, the government adopted rigid financial controls, capital allocation, etc., and though prices rose, the controls were relatively effective. There was no runaway inflation and finance was never a limiting or disruptive factor in the expansion of the war economy. The deficits rose in magnitude from 13.4 billion yen in 1941-42 to 76.6 billion yen in 1945-46 and note issue expanded to the same extent percentagewise.[2]

[1] For a discussion of Japanese public finance during the thirties see Seibi Hijikata *Zaisei Shi* (A History of Public Finance), (Tokyo: 1941). See also *Statistical Yearbook of Finance and Economy of Japan*, Part I, "Public Finance," (Tokyo: Ministry of Finance and Bank of Japan, Dec., 1948), pp. 9-254.

[2] See Jerome B. Cohen. *Japan's Economy in War and Reconstruction.* (Minneapolis: University of Minnesota Press, 1949), pp. 85-93.

Real difficulties were encountered immediately upon surrender when the relaxation of government authority resulted in an expenditure spree and a consequent sharp price rise. While the Bank of Japan note issue stood at 30 billion yen on August 15, 1945, in the ensuing six weeks some 40 billion yen more were paid out by military and civilian disbursing officers all over Japan. The resultant sharp rise in prices from September, 1945, to March, 1946, — a 295 per cent increase — led to a currency conversion in early 1946. This was effective for only a very short time and by November of 1946 the note issue was back to the pre-conversion level and prices rose sharply thereafter.[3] The magnitude of the deficits continued to increase from approximately 103 billion yen in 1947-48 to 166 billion yen in 1948-49. Government debt rose from 150 billion yen in mid-1945 to 531 billion yen in mid-1949. Note issue rose from 30 billion yen on August 15, 1949 to a peak of 355 billion yen by January 1, 1949.

A wage-price spiral set in, and at the peak in April, 1949, wages of all production workers in manufacturing were 168 times the 1934-36 base, while official wholesale prices were 186 times higher and effective retail prices 220 times higher. Not only did real wages decline during the postwar period but legitimate business was severely handicapped. Limited by official prices which were only changed once a year when the pressure became too great, legitimate enterprise grew increasingly short of working capital as wage and raw material costs rose (especially on the black market) throughout the year, while fixed official prices tended to force sales on the black market if a profit was to be obtained. To produce a fixed volume of goods required more and more working capital each year as the inflation heightened. This strain on the working capital position of companies forced them to resort to large "deficit" loans from the government's newly created Reconstruction Finance Bank (R.F.B.), which ostensibly began operations in January, 1947, to grant loans only for acquisition of capital equipment, plant rehabilitation, etc., but which quickly was diverted to grant loans to make good working capital deficits. Outstanding debentures of the RFB, most of which were sold to the Bank of Japan (the central bank) rose rapidly from 4 billion yen in January, 1947, to 145 billion yen in March, 1949. Loans of the RFB rose from 4 billion yen in January, 1947, to 131 billion yen

[3] See Hyoye Ouchi, *Financial and Monetary Situation in Postwar Japan.* (Tokyo: Nihon Taiheiyo Mondai Chosakai, 1948), p. 24.

in March, 1949.[4] Since ever increasing costs prevented firms, for the most part, from repaying their loans from the RFB and since the RFB could not therefore repurchase its debentures from the Bank of Japan, the loans caused by the inflationary costs were continually monetized by the central bank and more and more money was thereby drawn into circulation and never returned. Thus inflation begot inflation.

The spiraling inflation made prewar company capitalizations obsolete, but they were prevented from revaluing assets by a 65 per cent tax on revaluation "profits." Since there was in addition to a flat 35 per cent tax rate on corporate profits, an excess profits tax, the rates of which were based exclusively on earnings in relation to capitalization, any profit in a postwar economic environment where prices were 200 times the prewar level was subject to the top excess profits tax rate (20 per cent). With the addition to these national taxes of the prefectural enterprise tax, which was a 15 to 18 per cent rate on business profits, companies were taxed at a combined rate of from 60 to 65 per cent.[5] Thus, they were not only induced to sell in the black market because of the pressure of rising costs against fixed prices, but they were also led to attempt widespread tax evasion.

Both to hold down production costs and to ease the cost of living plight of the consumer, the government undertook a vast program of price subsidies. It is estimated that half of the cost of a ton of ingot steel is met by government subsidy. Imported foodstuffs were resold to consumers at 30 per cent less than the landed costs. To enable exporters to meet world market prices in spite of inflated yen costs at home, not only were their production costs directly subsidized, but in the absence of a fixed exchange rate a complicated system of implicit multiple rates was permitted to grow commodity by commodity. Thus, the Foreign Trade Board would purchase goods for export from the producer, paying the producer's cost of production plus profit in yen, and would then sell the goods in world markets for the going price in dollars, the dollars being paid into the SCAP[6] Dollar Trade Fund. If the Board paid 6,000 yen for a bicycle and sold it abroad for $20 there was thus established an implicit rate of 300 to 1. If wage and raw

[4] *Japanese Economic Statistics.* (Tokyo: Research and Programs Division, SCAP-GHQ, April, 1949), p. 110.

[5] See *Report on Japanese Taxation by the Shoup Mission SCAP-GHQ.* (Tokyo, 1949), I, 13.

[6] Supreme Commander for Allied Powers.

material costs of the bicycle producer rose and the Board paid him 8,000 yen but the product continued to sell for $20, a rate of 400 to 1 resulted. The compulsion of a single exchange rate to hold costs down, to rationalize to meet world market prices, was lacking. Thus, by subsidies and a multiple exchange rate system the Japanese producer was insulated from world market realities and his mounting costs merely resulted in bigger government budget deficits through either larger subsidies or greater deficiencies in the Foreign Trade Board's Fund. By the current fiscal year (1949-50) price subsidies had surpassed occupation costs to become the largest single item of expenditure in the Japanese budget, totaling 202 billion yen out of a general account total of 704 billion yen, or 28.7 per cent, compared with 13.2 per cent in the previous fiscal year.[7]

In the light of such conditions and in view of the apparent inability of occupation authorities to cope with the situation, the U. S. State and Army Departments issued the "Program To Achieve Economic Stabilization To Be Carried Out by the Japanese Government," in December, 1948 (so-called "Nine-Point Economic Stabilization Program") and early in 1949, Mr. Joseph Dodge, president of the Detroit Bank, was sent to Japan, with the rank of Minister, to bring economic order out of the fiscal chaos. The objectives set forth in the stabilization directive were:

1. To achieve a true balance in the consolidated budget at the earliest possible date.

2. To accelerate and strengthen the program of tax collection and insure prompt, widespread and vigorous criminal prosecution of tax evaders.

3. To assure that credit extension is vigorously limited to those projects contributing to the economic recovery of Japan.

4. To establish an effective program to achieve wage stability.

5. To strengthen, and if necessary, expand the coverage of existing price control programs.

6. To improve the operation of foreign trade controls and tighten existing foreign exchange controls. (This was also understood to mean the establishment of a single exchange rate, though it was not announced publicly.)

[7] *Special Monthly Economic Report* (Tokyo: Research Department, Bank of Japan, May, 1949), p. 27.

7. To improve the effectiveness of the allocation and rationing system, particularly to the end of maximizing exports.

8. To increase production of all essential indigenous raw materials and manufactured products.

9. To improve the efficiency of the food collection program.

The Dodge Mission was greeted with fear and suspicion. Within the Japanese government and to some extent among occupation authorities, it was felt that stabilization meant deflation and that deflation would bring hardship and unrest. The Japanese press pointed out that in the United States, in the midst of inflation, taxes had been reduced rather than raised, and that we were presently operating with an unbalanced budget.[7]

The theory of the stabilization program was, however, that Japan must be removed from the backs of the American taxpayer. The United States had been subsidizing Japan to the extent of some $500 million per year, largely used to purchase food and essential raw materials and fertilizers. Until Japan could raise production and export enough to pay for these essential imports, the United States would have to continue to fill the gap. To maximize exports, costs had to be brought down to the point where selling prices were in line with world market realities. To bring costs down inflation in Japan would have to be ended, payrolls trimmed and rationalization achieved. To end inflation, the budget would have to be balanced, reckless uneconomic credit extension checked and a single exchange established. It was to achieve such ends that Mr. Dodge's group labored and in a very short time produced a financial about-face in Japan, without resorting to a currency conversion, an accomplishment almost unprecedented in economic history.

The achievements of the Dodge Mission[8] may be summarized as follows:

1. It not only ended deficit financing, but produced what some have termed a "super-balanced" budget in that not only did revenues cover expenditures in all accounts, but were sufficiently in excess to provide for debt retirement of 120 billion yen (about one-fourth of the total outstanding Japanese national debt) and additional surplus funds to the extent of 130 billion yen to be used

[7] See Asahi Shimbun, Tokyo, April 21, 1949; Mainichi, Tokyo, May 6, 1949.

[8] For a summary statement by Mr. Dodge, see *Nippon Times*, (Tokyo, April 16, 1949), p. 1.

for investment purposes, for the rehabilitation of Japan's run-down capital plant. Since the total consolidated budget including general and all special accounts (such as operation of government-owned railroads and communication system) amounted to a net of 1.8 trillion yen, while the general account (covering the ordinary functions of government including occupation costs and price subsidies) totaled 704 billion yen, the extent of "super-balancing" is apparent. After a previous fiscal year overall deficit of some 160 billion yen, to carve out a "surplus" of some 250 billion yen was a remarkable budgeting feat. Indeed, there are some who feel that in this respect Mr. Dodge went too far.[9] They point out that in Japan approximately 80 per cent of the national debt is held by the Central Bank and the remainder by the commercial banks, since the Japanese masses have in the past preferred to use postal savings or savings banks rather than to purchase government bonds directly. Thus, to retire 120 billion yen or one-quarter of the national debt in one year might mean the return flow to the banking system, largely to the central bank, of a roughly corresponding account of currency and its retirement from circulation, since the central bank is under stricture to contract credit and the commercial banks have been using the funds to repay indebtedness to the Central Bank. Thus, one of the features of the Dodge program, if it were fully carried out, would be to withdraw roughly one-third of the currency from circulation in one year. This, his critics declare, is excessively deflationary, and they ask what would happen in the United States, if in one year, one-quarter of the outstanding national debt were retired and in the process one-third of the currency in circulation were withdrawn and sterilized.

2. The extent of American aid to Japan was explicitly shown for the first time and covered into the budget (as a special account) by the establishment of the Counterpart Fund. As shipments of U. S. aid are received, the Japanese government is required to deposit in the Fund the yen equivalent for the cost of the goods. It is anticipated that the Fund will acquire 145 billion yen during the course of the current fiscal year. Part of this Fund, to the extent of 62.5 billion yen, is already earmarked for debt retirement, while the remainder is to be used ultimately for investment. Approximately 27 billion yen of the Fund has already been earmarked for

[9] See "Anti-Deflation Measures," *Oriental Economist* (Tokyo, August 6, 1949); "Japan's Business Prospects," *Oriental Economist* (Tokyo, August 27, 1949), and "Deflation in Progress," *Oriental Economist* (Tokyo, September 3, 1949).

investment in the government-owned and operated railroad and communication system.

3. A single exchange rate was set at 360 to 1. Prior to the war, in the mid-thirties, the yen was worth about 28 cents. Immediately after surrender a military conversion rate of 15 to 1 was established. This was raised to 50 to 1 the following year, and in mid-1948, with the progress of inflation, to 270 to 1. Of the multiple rates in existence prior to the setting of a single official exchange rate, on the export side, some 80 per cent were lower than 360 to 1. The remaining 20 per cent of the export industries would have to rationalize to bring costs down into line with the new exchange rate requirements, while in those industries where the average export rate was already below the 360 to 1 level, any firms whose costs were out of line would either have to reduce them or retire from the field. Thus, it was felt that the compulsion of the new single exchange rate would bring efficiency to export producers.

4. The deficit loans and enormous credit expansion activities of the Reconstruction Finance Bank were halted. It was required that all RFB debentures be retired during the present (1949-50) fiscal year and that new loans by the RFB be permitted only to the extent of repayment of outstanding loans. Thus, the diminished activities of the RFB could no longer result in monetization of inflation-created debt. A number of government wholesaling and distribution corporations, known as Kodans, using RFB funds had accumulated unnecessarily large inventories and thereby added to inflationary pressures. These were eliminated and their functions restored to private enterprise.

5. Subsidies in some areas were eliminated and in others were reduced, though not to the extent that the Mission originally desired. In addition, all subsidies were explicitly shown in the new budget in contrast to the large degree of concealment in the previous budget. A program for final elimination of all subsidies was suggested "to bring the Japanese economy down off its stilts," as Mr. Dodge put it. Of the present 202 billion yen of subsidies in the budget, one-half is to be eliminated in the next fiscal year and the remainder in the fiscal year thereafter. This aspect of the program was the subject of sharp debate[10] particularly among occupation officials, since it was held that the elimination of subsidies too rapidly, or in too great amount, would start prices spiralling

[10] See *The Economy in Transition* (Tokyo: Japanese Economic Stabilization Board, July 12, 1949), pp. 1-19.

upward again, thereby touching off renewed wage demands and thus the wage-price spiral would be reactivated. It was indicated, for example, that if all subsidies, direct and indirect were eliminated, the price of steel would triple. In reply Mr. Dodge urged rationalization of both industry and government to reduce costs. A change in the allocation procedure was advocated to bring about a "centering" of production in a few plants in an industry, so that each might operate at a higher percentage of capacity and thereby sharply reduce unit costs. Previously the allocation procedure had been a "buckshot" affair, with a little given to each firm to keep it in operation as a contribution toward the "democratization" of industry. Short of raw materials, operating at low capacity, Japanese producers nevertheless retained virtually full labor staffs because of the traditional paternalistic view of employers that employees were members of the "company family" and once employed were, during good conduct, to be retained. As a result many workers were being paid for doing nothing and unit costs of production were abnormally high. While the new allocation procedure would undoubtedly result in favoring a few firms in each industry, it would also reduce costs considerably and this, Mr. Dodge held, would counterbalance the impact of the elimination of price subsidies.

6. Finally, stock markets in the principal cities of Japan, which had been closed since the end of the war, were reopened in order to stimulate the flow of capital into industry and to maximize security investment. With industry in need of long-term capital and with an enormous quantity of formerly Zaibatsu-held securities to be disposed of to new investors through the government's "Securities Coordinating Liquidation Commission" and the "Holding Company Liquidation Commission" it was felt to be important to attempt to create much wider public acceptance of the concept of security ownership. In the meantime, however, until this tradition could be established to direct the flow of bank credit into useful productive and economic channels, and to determine credit policy, a Credit Control Board, modeled along the lines of the U. S. Board of Governors of the Federal Reserve System, was established consisting of seven persons, including the governor of the Bank of Japan, representatives of the Finance Ministry, the Economic Stabilization Board, and of commerce, industry, and agriculture.

In the field of taxation Mr. Dodge made no recommendations since he did not wish to prejudge and thereby prejudice the work

of the Shoup tax mission. He did, however, indicate informally to the Japanese government that it would have to maximize tax revenues, and he rejected a government request for an immediate reduction of tax rates. About the time he left Japan (May 1) a tax mission, headed by Professor Carl S. Shoup of Columbia University arrived.

The Shoup Tax Group found that the Japanese, both individuals and corporations, were being subjected to such unduly high tax rates that widespread evasion was the rule, and that not only were the rates being ignored by the taxpayer, but by the tax collector as well. In what they were actually paying, the Japanese were not being overtaxed; in what they might be expected to pay under full enforcement of existing legal rates, they were. To remedy this situation, to suggest a tax structure which could be fully enforced without undue hardship, and yet to frame recommendations which would not upset the Dodge stabilization program, required care.

On an overall basis, the Mission's findings stayed within the budget guideposts previously established. The reductions recommended in the national government taxes would result in some 60 billion yen less revenue in the next fiscal year. If the program to cut price subsidies by 100 billion yen were followed it would not only cover this, but also allow repeal of the regressive and unpopular transactions tax (a 1 per cent turn-over tax levied at manufacturer, wholesaler, and retailer levels) which was to yield 45 billion yen in revenue during the current fiscal year. Thus, a reduction of 100 billion yen in national government revenues would be paralleled by a corresponding reduction in expenditures and the balanced budget preserved. The Japanese public, however, would not gain additional purchasing power since the local governments, struggling to finance the requirements of centrally prescribed programs and responsibilities, would be allowed to increase taxes by some 40 billion yen over existing levels. Thus, the 60 billion yen national government tax reduction would be partly cancelled by the 40 billion yen increase at the local level. If the 100 billion yen price subsidy cut were carried through and therefore an additional 45 billion yen of national government tax revenues (the transactions tax) were eliminated, the gain to the Japanese public might be expected to be counterbalanced by probable price increases resulting from the price subsidy reduction.[11] Thus, there would be

[11] For a more extended discussion see *Report on Japanese Taxation, op. cit.* Vol. I, chaps. 1, 2.

no additional purchasing power thrown on the inflationary fire and the austerity contemplated by Mr. Dodge would be preserved. On the other hand, a realistic set of tax rates, which could be fully enforced and upon which respect for tax laws could be built, would have been installed.

The major recommendations of the Tax Mission may be summarized under five headings:

1. *Personal income tax.*—The whole level of rates was lowered. Previously the rates had ranged from 20 per cent on the first 20,000 yen of taxable income to 85 per cent on taxable income of 5,000,000 yen and over. The Mission recommended rates ranging from 20 per cent on the first 50,000 yen of taxable income to only 55 per cent on taxable income in excess of 300,000 yen. Obviously the most striking feature of the proposal is the relief afforded at the upper level. Coupled with the 55 per cent top rate, however, the Mission recommended the enactment of an annually recurring net worth tax at rates which would enable the tax to be paid out of income. Net worth up to 5 million yen is exempt. Thereafter the tax is graduated from a one-half of 1 per cent rate on net worth in excess of 5 million yen, but not in excess of ten million yen, to a top rate of 3 per cent on net worth in excess of 50 million yen. The Mission felt that at these rates it would hardly ever pay the taxpayer to try to evade the tax by hiding his assets in a non-income producing form, as in bank notes or in precious stones, since in this form his wealth earns nothing, whereas if he puts it to work earning a return the combined burden of the income tax and the net worth tax will still leave him something.

The oriental penchant for negotiation, compromise, and bribery in tax matters had rendered the previously upper-rate brackets unenforceable. No one in Japan had actually been paying the top rates of 75-85 per cent. If anyone had been, and to these were added the 15 to 18 per cent prefectural enterprise tax and the 5 to 10 per cent local inhabitant tax, the total tax liability would have exceeded 100 per cent. Reduction of the top brackets was simply recognition of the realities of the situation. The upper income taxpayer was further benefited by the raising of the credit from 15 to 25 per cent of dividend income allowed against personal income tax liability. On the other hand the mission recommended full inclusion of capital gains in taxable income, not merely 50 per cent as had been provided. Full deduction of capital losses,

however, is to be permitted and gains and losses may be averaged forward over five years.

At the other end of the scale, the smallest taxpayer (and almost every income-earner in Japan as a result of the inflation has had his wage lifted into the income tax liability range), had his basic deduction increased from 15,000 yen to 24,000 yen, while credit for dependents was raised from what had been the equivalent of 9,000 yen (actually it had been a credit against the tax of 1,800 yen per dependent) to 12,000 yen deduction from income, for each dependent. The repeal of the present provision that requires all members of a co-living family to file a joint return will help small income groups, particularly farmers and small shopkeepers, since each independent income-earner may now file a separate return and each claim the basic exemption, though they live together. The present earned income deduction of 25 per cent of the first 150,000 yen of gross earned income was reduced to 10 per cent (up to a maximum of 20,000 yen on 200,000 yen of gross earned income) largely to eliminate the unduly large discriminatory differential in favor of workers as against farmers and small shopkeepers, who are not eligible for it. To illustrate, a farmer or a small shopkeeper, married with two children and earning an annual income of 100,000 yen must pay a tax of 17,850 yen, whereas a laborer of the same status would pay only 9,600 yen because of the 25 per cent earned income credit. Under the revised plan the farmer or small shopkeeper will pay 8,000 yen, the laborer 6,000 yen. In yet another respect the farmers and small shopkeepers were being hit as compared to wage workers, in that they were subject to the prefectural enterprise tax. The Mission recommended that the farmer be exempt from this tax. The farmers' income tax is to be withheld at the source, however, to reduce evasion.

2. *Taxation of corporations.*[12]—The Mission recommended that the excess profit tax be repealed and that corporations be allowed to revalue assets with only a 6 per cent tax to be applied to revaluation profits. Thereafter corporations are to be subject only to the flat 35 per cent rate presently in the law. The need for revaluation was mentioned previously. Failure to allow revaluation was seriously hampering the operations of legitimate, established companies with prewar capitalizations and forcing most to evade taxes. The existing 20 per cent withholding rate on dividends is to

[12] For a more elaborate treatment see *Report on Japanese Taxation, op. cit.*, Vol. I, chap. 6; Vol. II, chap. 7; Vol. III, Appendix C, "Revaluation of Assets."

be repealed, since the 35 per cent rate is itself considered a withholding tax. A new feature is introduced in the recommendation that corporations be required to pay an interest surcharge of 1 per cent a year on earnings they retain and fail to distribute as dividends. The special 65 per cent tax on inventory profits is to be repealed. Loss carry forward and carry back is to be permitted. Stricter enforcement of the provisions against deducting capital outlays all in one year, a widespread practice overlooked by many Japanese tax officials, is urged, as is also disallowance of heavy "entertainment" expenses now commonly deducted as business expenses.

3. *Local government finance.*[13] — The Mission found the local governments struggling to meet the costs of such increased responsibilities as police, education, health insurance, etc., all of which had been imposed upon them without adequate financial support. It therefore urged that the tax revenues of localities (cities, towns, and villages) be increased from 80 billion yen to 120 billion yen, while prefectural tax revenues remain fixed at 70 billion yen. It recommended a separation of tax sources so that prefectural and localities would no longer share the same, a source of much irritation in the past. The localities were to depend exclusively upon the inhabitants tax and the real property tax, the prefectures mainly upon the enterprise, admission, and amusement taxes. The inhabitants tax is a combination local poll and income tax. In addition to a fixed flat sum per taxpayer there is an additional sum based on his income. In some areas a third element of property owned is used in levying the tax. The Mission recommended that this element be dropped in view of its proposal to overhaul the real property tax by reappraisal. At present the real property tax is levied at the fantastic rate of 500 per cent upon a wholly unrealistic 1938 rental value base. The Mission urged a reappraisal at present prices, and indicated that if this were done a 1¾ per cent rate on present capital values would bring in approximately 50 billion yen, as compared with a 14 billion yield at a 500 per cent rate on 1938 rental values.

An innovation is the proposal that the prefectural enterprise tax have its base enlarged from profits to "value-added." The tax would be imposed on gross receipts minus the cost of everything bought from other business firms, including capital equipment such

[13] For a more detailed discussion see *Report on Japanese Taxation, op. cit.*, Vol. II, chaps. 11, 12, and 13 and Vol. III, Appendix A "Finance of Local Governments."

as buildings and machinery. There would be no depreciation or inventory accounting involved. The Mission recommended this base because it is economically neutral. It does not favor the vertically intergrated firm (as does the transactions tax) nor does it discriminate against the use of machinery and other capital equipment. The admissions tax rate was reduced from 150 to 100 per cent, which is still the highest in the world. To aid the poorer localities the Mission recommended that national government subsidies, subventions, etc., be shifted to the equalized grant-in-aid system familiar in Great Britain and the United States.

4. *Indirect taxes.*[14]—The sale of cigarettes and smoking tobacco in Japan is presently a government monopoly yielding 120 billion yen in revenue, as compared to some 300 billion yen for the personal income tax and 27 billion yen for the corporate income tax. If liquor taxes are added to tobacco revenue the total is some 200 billion yen or two-thirds as much as the income tax yields. Before the war Japan had obtained the main share of her tax revenue from indirect taxes. It has only been in the last four years under the Occupation that the role of the direct tax has been stressed. Although the Mission recommended that the 15 per cent reduction in liquor taxes undertaken in May, 1949, be restored, and the yield of the liquor taxes thereby be raised from 65 to 80 billion yen, it attempted to lessen the importance of the role of indirect taxes, which are generally regressive and bear more heavily on the lower income groups, by recommending complete elimination of the long-established textile tax which was levied at 40 per cent on silk, rayon, and wool, and at 10 per cent on cotton and staple fiber. It also urged repeal of the transactions tax if reductions in budget expenditures in the coming fiscal year permit.

5. *Administration and enforcement.*[15]—This has perhaps been the weakest element in the Japanese tax system in the past, and over the last two years direct intervention of Occupation forces has been necessary to meet the tax revenue goals. The self-assessed income tax introduced in 1947 was understood neither by the taxpayer nor by the tax collector. The thought that one should accurately reveal his real income to tax authorities was wholly alien to the oriental mind. As a result fully 75 per cent of the returns filed were false, and arbitrary reassessment by harassed, untrained,

[14] For a more detailed treatment see *Report on Japanese Taxation, op. cit.* Vol. II, chaps. 9 and 10.

[15] For a more extended discussion see *Report on Japanese Taxation, op. cit.*, Vol. II, chap. 14, and Vol. IV, Appendix D, "Administration of the Individual and Corporate Income Taxes."

and often unscrupulous tax collectors resulted. The setting of tax goals necessitated by the failure of self-assessment worked to the detriment of the little or honest taxpayer from whom an unjustifiably large sum was exacted to enable the tax office to meet its quota, while the larger taxpayer could exert pressure, postpone his tax settlement until after the quota had been met (usually by undue exactions from those unable to resist), and then when the tax office was no longer under pressure, negotiate a very favorable settlement at a figure considerably lower than his legal liability. In some cases the administrative difficulties were the result of omissions in the law itself. For example, there was no penalty provided in the law for failure to file a return. It was worth taking a chance. If you did not file and were overlooked, as frequently happened, you escaped payment. If you were discovered, you simply paid the tax. For these and many other administrative problems, too numerous to detail here, the Mission made specific suggestions, all designed to the end that point two of the stabilization directive could be carefully carried out, based on a newly revised and equitable tax system.

Mr. Dodge made a second visit to Japan in November, 1949, at the time that the new budget for the fiscal year 1950-51 (starting April 1, 1950) was being compiled. His presence assured continuation of the balanced budget policy and strict adherence to the tax changes suggested by the Shoup Mission. A tax reduction of 71.3 billion yen, or 14 per cent, was made possible primarily by a saving of 89 billion yen in price subsidies heretofore paid to producers of iron and steel, fertilizer, etc. Substantial continued debt retirement is provided for in the new budget, which is to total 660 billion yen (general account) compared to 741 billion yen for fiscal year 1949-50. To maintain a balance in the special accounts the government will raise railroad freight rates by 80 per cent and maritime shipping rates by 93 per cent. As a partial offset, and largely to counter British devaluation and make unnecessary Japanese devaluation, floor prices on export goods have been eliminated, thereby permitting export prices to fall to more competitive levels. Control of foreign trade has also been further relaxed by permitting import for private account subject only to exchange control which the Japanese, themselves, are now to administer. The reaction of Japanese businessmen, long accustomed to government subsidies and rising prices, was that the new budget would "strengthen current deflationary trends" and that the debt retire-

ment provided was excessive and should give way to "further use of funds for loans for industrial development."

Perhaps the most succinct summary was that of the TOKYO TIMES, which declared: "In short the prescription prepared by Mr. Dodge for the Japanese economy has turned out to be bitter again. If only to ascertain whether the bitter pill prescribed by Mr. Dodge is a good cure, the Japanese people should spare no further efforts."[16]

It is yet too early to judge fully the effectiveness of the recently undertaken stabilization program for Japan. In terms of fiscal policy as well as of the objectives sought it is sound. First indications seem to show that it has taken hold and is working. Note issue declined steadily during 1949, and from its peak of 355 billion yen in December, 1948, had fallen to 295 billion yen by the beginning of October, 1949. Prices reached a peak in April, 1949, and have since then been falling, the first decline in fifteen years. The danger is not so much that the program will not work, but rather that it will work too well, thereby emboldening its critics to demand changes and modifications which will vitiate the policy. There are powerful groups in Japan which stand to gain from further inflation, and they are ready to seize every opportunity to foster it. Indeed, there were signs in Japan in the summer of 1949 that these groups were already at work. With the sudden cessation of RFB lending in April a credit drought developed because of delays in getting the Counterpart Fund operating and because the small increase in commercial bank lending was not nearly sufficient to fill the void left by the RFB.[17]

Furthermore, the government, starting in April, began to keep on hand a cash balance five to six times the customary size, thus drawing an unnecessarily large sum of money out of circulation instead of paying its bills (which were three or four months in arrears) more promptly, thereby releasing funds when they were badly needed.[18] In addition a rumor developed that the Counterpart Fund was going to lend at much lower rates of interest (5 or 7½ per cent) than the Japanese customarily charged. (The commercial rate for short-term paper of two to four months is 11 per cent, and for long-term notes of one to five years, 14 per cent. Normally no private loans are made in Japan for periods beyond

[16] Tokyo, November 16, 1949, p. 4.
[17] See "Economic Review" in *Nippon Times*, (Tokyo, September 20, 1949), p. 4.
[18] See *Oriental Economist* (Tokyo, September 17, 1949), p. 916.

five years.) Thus, those firms that wanted to borrow and would have been able to do so at the commercial banks were reluctant to act until the Counterpart Fund rate was announced. All these factors combined to create a far more severe transitionary period and downward trend than wise fiscal management would have permitted. Cries of anguish arose in the Japanese press. That they were overdone is suggested by the very modest price and note issue declines that actually occurred. But they led to numerous serious suggestions for overcoming the "slump," the adoption of any of which, or several together, would have impaired the stabilization effort. Proposals were made for much larger public works appropriations, for a supplementary budget, for funds for unemployment relief, for a new bank to finance export producers, for government guaranty of commercial bank loans, for a Housing Finance Corporation to finance the alleviation of the housing shortage, etc.

With the absolute authority which the Occupation exercises over all phases of Japanese economic life, given competent direction and careful administration, there is no reason why inflation, on the one hand, cannot be contained, and a severe deflation, on the other, avoided. Skilful coordination, control and manipulation of Counterpart Fund operations, credit policy, government expenditures, taxes, etc., in an economic laboratory unparalleled in financial history, ought to produce a balanced middle course so essential for Japanese economic recovery. It is to be hoped that U. S. financial experts of the highest caliber will interest themselves in this unique undertaking and lend the benefit of their advice and experience. It would be most unfortunate if, despite the favorable environment of complete control, lack of wise continued direction caused a fumbling of the new program.

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